

**Working Paper 2010-1**

**Towards a more rational tax treatment of collective investment vehicles and their investors<sup>1</sup>**

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## **The Retirement Policy and Research Centre**

The Retirement Policy and Research Centre is pleased to publish this Working Paper on the taxation treatment both of 'collective investment vehicles' in New Zealand and of the New Zealanders who use them.

This Working Paper builds on Michael Chamberlain's and Michael Littlewood's presentations and papers given to the Retirement Policy and Research Centre's Symposium 09 - Tax, Saving, Welfare and Retirement: Have we lost our way?<sup>4</sup> Both authors have a long experience in superannuation and actuarial work and in the management of superannuation schemes.

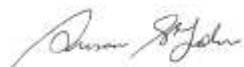
Until 2000, New Zealand had a relatively simple tax treatment of collective investment vehicles (CIVs) where the CIV's income was taxed at the top personal rate of tax (33%) that was also the corporate tax rate and the rate that applied to trusts. Under the 'taxed/taxed/exempt' regime (TTE), contributions to CIVs that were workplace superannuation schemes were made out of the employee's after-tax income (the employer's contributions were also taxed at 33%) and withdrawals were treated as tax-paid capital.

This Working Paper analyses the relatively recent history of the increasing complexity that culminated with the introduction of 'portfolio investment entities' (PIEs). It urges a principles-based discussion of reform of the tax treatment of CIVs to move New Zealand away from a 'silo' development of a rules-based regime to return to a more fundamental definition of 'income'.

The Working Paper makes specific recommendations for a reform of the tax treatment of investment 'income'. Those recommendations also have significant implications for equity in relation to the interface between 'income' and income-tested elements of the welfare system.

The Retirement Policy and Research Centre welcomes this contribution to a needed debate. However, the views expressed in this Working Paper are those of the authors.

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Dr Susan St John  
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<sup>4</sup> Papers and presentations from Symposium 09 are available at <http://www.symposium.ac.nz/09/>.

## Scope of the paper

The paper covers different aspects of the tax system and is divided into parts that attempt to draw those threads together with respect, particularly, to the tax treatment of 'collective investment vehicles' (CIVs). The framework is as follows:

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## Abstract

The income tax treatment in New Zealand of different forms of saving is somewhat removed from the relatively simple arrangements in the 1990s. It is now complex, costly, distortionary, expensive to regulate and has not been subjected to appropriate policy analysis. The total tax paid by savers directly and indirectly can now bear little relationship to the tax that would have been payable had all income been earned directly. The large recent extension of income-tested 'tax credits' compounds the problem.

A preferable way to tax savings would be to treat investment returns as income on which the ultimate tax burden is borne by savers at their appropriate marginal tax rate. Any required interaction with income-tested elements of state-provided payments would then include all 'income' and not, as now, some 'income'. This would bring New Zealand closer to the principle of comprehensive income taxation in which ability to pay is measured by all income.

## Summary

The tax treatment of collective investment vehicles (CIVs) such as superannuation schemes and unit trusts is both illogical and unfair. 'Income' earned by individuals through CIVs is taxed in different ways and, when it comes to considering the impact of the individual's 'income' (however calculated) with state-initiated payments and levies, some 'income' is counted but other income is not.

This paper<sup>5</sup> summarises the present position and suggests a principles-based solution. The Tax Working Group has suggested changes to the government that may reduce some (but not all) of the current discontinuities in the tax system. New Zealand needs to return to first principles for the taxation of CIVs and their investor/members.

The Portfolio Investment Entity (PIE) regime, started in 2007, was intended to make it more attractive for savers to make portfolio investments through CIVs and to align the marginal tax rates with the marginal tax rates of some individuals. It was also intended to reduce the need for many with investment income to make an annual tax return to the Inland Revenue. However, the PIE regime has introduced more complexity and distortions without solving the problems of the past.

This paper recommends a broad framework to replace current arrangements that does not require the invention of artificial definitions of income. Instead, it attempts to recognise the true economic nature of the transactions involved. Adopting a principles-based framework will also make the interaction between 'income' and income-tested payments and levies of all kinds by the state more coherent and fairer.

The recommended CIV tax regime requires that investor/members are taxed on the basis that they had earned the income directly. A practical foundation that will see the income of investor/members calculated in ways that will be familiar to taxpayers is suggested.

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<sup>5</sup> The framework suggested in Part C of this paper for the tax treatment of CIVs is based on a submission by the Association of Superannuation Funds of New Zealand (now called Workplace Savings NZ) in September 2005 (Association of Superannuation Funds of New Zealand Inc, 2005). Michael Littlewood was the principal author of that submission. This paper also draws on three articles by Michael Littlewood published in March/April 2007 by *The Independent* and also on a paper by the authors (Chamberlain & Littlewood, 2009).

## Part A The current environment

Part A summarises the current tax environment in three paragraphs, as follows:

- A1: Income tax (pages 4-6);
- A2: State interventions in 'income' (pages 7-14);
- A3: The way tax affects collective investment vehicles or CIVs (pages 15-25).

### A1: Taxing income

#### A1.1 Progressive tax on 'income'

New Zealand has a progressive system of taxation for the income earned by individuals.

Income directly received by an individual is taxed as follows:

**Table 1 – income tax rates for individuals as of 1 April 2009**

Income band (for tax year)	% of income in this band	Accumulated \$ at top of band	Average % at top of band
To \$14,000	12.5%	\$1,750	12.5%
\$14,001-\$48,000	21.0%	\$8,890	18.5%
\$48,001-\$70,000	33.0%	\$16,150	23.1%
\$70,001 +	38.0%	n.a.	n.a.

'Income' in a tax year ending 31 March includes salary/wages from employment, directly received investment income (such as bank interest, bond returns and dividends from shares) and net rent from directly owned investment properties.

Dividends carry imputation credits with them that recognise the tax paid at the company level. This flow-through process recognises shareholders as the ultimate owners of the company. Dividend income is then effectively taxed once at the shareholder's appropriate marginal tax rate. Profits that the company retains are, however, taxed at the company rate, currently 30%.

Employers deduct tax from salary/wages under the 'Pay As You Earn' (PAYE) system. This attempts to deduct the 'right' amount on a 'per pay period' basis so that an employee working for a single employer for a full tax year (ending 31 March), owes no more tax and collects no refund in respect of that employment.

There are difficulties with this approach. They include:

- Many taxpayers have more than one job<sup>6</sup>;
- The employer cannot allow for investment or other income earned directly by the employee, except where the employee has a special tax code;
- Income-related payments from the state relate to annual income directly received by the household. A single employer may know how much an employee earns but two employers cannot.

<sup>6</sup> Statistics New Zealand data show that, in the quarter ending 31 March 2008, there were 1,731,219 people in the workforce (where income tax is deducted at source and the self-employed). Of those, 74,040 (4.2%) held two jobs and 5,220 (0.3%) held three or more jobs. Those proportions are virtually unchanged over the five years 2003-2008. Source: LEED annual tables available from [www.stats.govt.nz](http://www.stats.govt.nz) [here](#).

A progressive system's objective is that those who earn more make more of a contribution to the 'common weal' both in dollars and as a proportion of their incomes. This paper does not argue for a different system through which tax is calculated but does observe how far the overall arrangements have deviated from the progressive system implicit in Table 1.

Where a taxpayer can choose to receive economic income in different ways to maximise net disposable income, that can undermine the progressivity intent of the whole system.

Regardless, it seems wrong that a taxpayer can choose whether to pay tax and how much to pay. Elements of both are now built into the current structures.

### **A1.2. Indirect income**

Individuals do not receive all income directly. They may have money invested in different vehicles, some of which are 'final' taxpayers; others issue 'income' with a withholding tax deducted at source but where the before-tax income is included in the individual's personal total with the deducted tax as a credit against the amount due from the individual.

Table 2 summarises the most common sources of indirect income.

**Table 2: Different forms of indirect income<sup>7</sup>**

<b>Vehicle name</b>	<b>Tax treatment (summary)</b>
1. Registered superannuation scheme	Income taxed at 30%; final taxpayer. Contributions by employer subject to Employer Superannuation Contribution Tax (ESCT) either at 33% or related to employee's marginal rate.
2. Portfolio Investment Entity (PIE)	Income taxed at member's Portfolio Investor Rate (PIR) of currently 19.5% or 30%; final taxpayer. From 1 April 2010, PIRs become 12.5%, 21% and 30%.
3. Company	Dividends are taxed as shareholder's income. Where the company has paid company tax on its income, the shareholder can have an imputation credit as an offset.
4. Unit trust	Income taxed as if a company with dividends paid as income to unit-holders.
5. Unregistered superannuation scheme	As for 1. above but employer contributions are subject to Fringe Benefit Tax (FBT) as though they were income of the employee.
6. Family trust	Trust pays 33% as a final taxpayer; distributed beneficiary income taxed in individual's hands rather than the trustee's. Capital distributions can be from after-tax income that has been taxed at 33%.
7. Bank account	Interest income is directly attributable to the taxpayer. The deposit taker deducts "resident withholding tax" at 19.5% <sup>8</sup> , 33% or 38%. That becomes a credit against the taxpayer's final tax liability.

<sup>7</sup> There is more detail on the tax treatment in Appendix I.

<sup>8</sup> To become 21% from 1 April 2010.

Other CIV possibilities include 'group investment funds' (GIFs), 'limited partnerships' and 'loss-attributing qualifying companies' (LAQCs). In all cases, income and losses are flowed through to investors.

## **A2: State interventions in 'income'**

The state intervenes in a number of ways to support an individual's or household's income. This paragraph A2 provides a necessarily brief summary of a complex web of interventions that are affected by the amount of 'other' income received by the individual/household. There are also other reasons why the state needs to know how much 'income' someone is receiving. Putting these interventions and income tax/levies together often means very high deductions for an extra dollar of 'income'.

### **A2.1 The current tax and benefit system: summary**

The necessarily brief analysis of state interventions in the definition of 'income' in this paragraph A2 leads to a number of conclusions:

- a) The array of state-provided payments/levies is very complex and entitlements potentially apply well up the income scale.
- b) Many New Zealanders are now affected by income tests. For example, there were 203,000 families in receipt of the Working For Families 'tax credits' directly from Inland Revenue, totalling \$2.63 billion in the year ended 30 June 2009 (Inland Revenue, 2009, p. 41).
- c) Direct taxable pay (rather than 'economic income') is the key driver for income-tested payments.
- d) There is a variety of ways in which assets and income can be 'sheltered' from direct connection with the economic owners of that income.
- e) Income derived through the various tax-based vehicles is not aggregated for either income tax or for the application of income-tested payments.
- f) The interaction of pay, benefits and income tax is now very complicated.
- g) There are now significant incentives for individuals to arrange their financial affairs to maximise disposable incomes.
- h) Previously, income tests applied mainly to individuals with relatively low taxable incomes and so, probably, with relatively few other assets or income streams. That gave them limited opportunities to structure their income and assets efficiently. Income tests now potentially affect earners who have the resources to re-structure the way they receive income.

The balance of this paragraph A2 details the reasons for these conclusions.

### **A2.2. Payments by the state<sup>9</sup>**

The State uses 'income' to calculate a number of different entitlements and obligations. Items A2.2.1 to A2.2.4 are under the 'Working for Families' heading.

The amount of 'income' a person receives affects the following entitlements:

#### **A2.2.1 Family Tax Credit (FTC)<sup>10</sup>**

Families receive a payment that depends on the number of children aged 18 or younger in the household. The annual amount is \$4,487 for the first child under age 16 (\$5,198 if age 16 or more). For each additional child, a further amount is payable ranging from \$3,119 to \$4,651 a year depending on age.

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<sup>9</sup> Paragraph 2.1 draws on St John & Rankin (2009) – benefits are as of 1 April 2009.

<sup>10</sup> Details from the Inland Revenue's web site at [www.ird.govt.nz](http://www.ird.govt.nz) [here](#).



The amount payable abates if the household income exceeds \$36,827 a year (as of 1 October 2008). The abatement rate is 20% of each dollar of family income above the threshold.

#### **A2.2.2 In-work Tax Credit (IWTC)**

In addition to the FTC, the IWTC is payable to families who work a minimum number of hours a week. Again, it depends on the number of children, the household's total income. It also depends on the number of hours worked (20 hours for a sole parent; 30 hours in total for a couple).

The amount payable is \$3,120 a year for up to three children plus \$780 for each extra child. The IWTC is abated in the same way as the FTC. Where both are payable, the FTC is abated first.

#### **A2.2.3 Minimum Family Tax Credit (MFTC)**

If a family earns less than \$21,860 a year before tax, the MFTC ensures its net income is at least \$18,460 a year. The 'hours worked' test is the same as for the IWTC. The nature of the benefit means it is necessarily based on the family's 'other' income.

The MFTC abates at 100% for income above the minimum.

#### **A2.2.4 Parental Tax Credit**

Up to \$150 a week is payable to the family of a newborn child for the first eight weeks if paid parental leave does not apply. The amount actually paid depends on the family's before tax income, hours of work and the number of new-born children in a year.

#### **A2.2.5 Independent Earner Tax Credit (IETC)**

A person who does not have a family can qualify for the Independent Earner Tax Credit<sup>11</sup> of \$520 a year. In summary, the person must not be receiving another income-tested state benefit (and neither must the employee's partner). The IETC applies if the person's taxable income is at least \$24,000 (but less than \$48,000) for a tax year.

If taxable income is more than \$44,000 a year before tax, the IETC reduces by 13 cents for each dollar earned in excess of \$44,000. There is no IETC if before-tax income exceeds \$48,000 a year.

#### **A2.2.6 Student loan payments**

Student loans are interest-free as long as the borrower is tax resident in New Zealand. However, principal payments are required if taxable income is more than the threshold of, currently, \$19,084 a year<sup>12</sup>.

The required payment is 10 cents for each dollar of 'income' above the threshold.

#### **A2.2.7 Student Allowances**

The government pays a weekly Student Allowance<sup>13</sup> for a total of 200 weeks of an approved secondary or tertiary course. The student must generally be at least age 18 and studying full-time. The weekly amount

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<sup>11</sup> Details from the Inland Revenue's web site [www.ird.govt.nz](http://www.ird.govt.nz) [here](#).

<sup>12</sup> Details from the Inland Revenue's web site [www.ird.govt.nz](http://www.ird.govt.nz) [here](#).

<sup>13</sup> Details from the Inland Revenue's web site [www.ird.govt.nz](http://www.ird.govt.nz) [here](#); also from a personal communication with StudyLink.

depends on age and whether the student is living at home and ranges from gross \$122.77 to \$184.17 a week.

The student may earn up to \$192.01 a week (\$9,985 a year) with no effect on the amount of Student Allowance payable. Every dollar earned by the student above that threshold reduces the Student Allowance by the same amount (100% offset).

If the student is aged 23 years or less, the Student Allowance is tested against the parents' household income above \$52,019 a year. The abatement rate is 25%<sup>14</sup> of household income above the threshold and is fully abated at household income of \$78,418 a year before tax where the student is living at home. If the student is living away from home, the Student Allowance is fully abated at household income of \$85,018 a year. The income test applies even when the parents do not live in the same household. Where there is more than one Student Allowance payable, \$7,000 a year of household income is deducted for each qualifying student before applying the above test in respect of each Student Allowance. Once the test applies, the abatement rate would be a combined 50% in respect of two Student Allowances.

#### **A2.2.8 Child support payments**

A person who is a child's custodian may be entitled to child support payments from the 'liable parent'. The amount payable depends on the liable parent's income<sup>15</sup>. A 'living allowance' is deducted for the liable parent (based on that parent's circumstances). Taxable income of up to \$114,191 a year counts in the calculation. If the custodial parent is receiving the Domestic Purposes Benefit, the child support payment is paid to Work & Income New Zealand to offset this cost.

The total payment deducted from the balance depends on the number of children and the children's living circumstances but can be between 12% to 30% of the balance of the liable parent's income. For those on low pay or welfare benefits, a minimum of \$799 a year is payable. This is not strictly a state benefit but is administered and enforced by the state.

There may also be maintenance obligations towards the custodial parent. They will often be set in relation to the liable parent's income but not usually in the formal manner of child support payments.

#### **A2.2.9 Welfare benefits**

The state also pays a number of income-tested welfare benefits. These include the Domestic Purposes Benefit, Unemployment Benefit, Sickness Benefit and Invalid's Benefit. These are all income-tested for relatively low levels of taxable income and in respect of the total income of the beneficiary and any spouse/partner.

For present purposes, it is unlikely that a welfare benefit recipient would have significant CIV-derived income. For completeness, a description of the conditions applicable to the Domestic Purposes Benefit (as an example) are included in Appendix II.

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<sup>14</sup> In fact, the abatement rate is 28.57143% of parental income above the threshold. At the lowest marginal tax rate of 12.5% (to the student's income of \$14,000 a year), this is equivalent to a net 25% reduction.

<sup>15</sup> Details from the Inland Revenue's web site [www.ird.govt.nz](http://www.ird.govt.nz) [here](#).

## **A2.3 Other pay-related concepts**

With respect to an employer, taxable 'pay' also matters for reasons other than income tax.

### **A2.3.1 ACC levies**

Both the employer and the employee pay levies to the ACC that relate to the employee's pay. The employer's levy depends on the job classification. The employee's levy is now 1.7% of taxable pay (2.0% from 1 April 2010). In both cases, the maximum pay that counts is currently \$106,473 a year (1 December 2009).

### **A2.3.2 ACC income-related benefits**

The ACC pays 'earnings-related compensation' to an employee who, following an accident, is unable to work. The maximum amount payable is 80% of the employee's taxable pay at the date of the accident, again with a present maximum of \$106,473 a year.

Any change to taxable pay, including elected reductions through 'salary sacrifice' (see paragraph A2.4 below) will therefore potentially have a direct impact on earnings-related compensation.

### **A2.3.3 KiwiSaver**

When an employee joins a KiwiSaver scheme for the first time, the employee must contribute at least 2% of taxable pay if the employee is aged 18-64. The employer must also contribute 2% until the employee chooses to start a 'contributions holiday' (possible after at least 12 months' membership).

For employees who first join KiwiSaver after age 60 the employer subsidy continues for 5 years as long as the employee continues to pay 2%.

## **A2.4 'Income' that 'counts'**

When the state uses 'income' as a basis for calculating benefits, determining entitlements or abating them, it is almost always the income that is subject to income tax that matters<sup>16</sup>.

Non-taxable benefits or benefits that are subject to either Employer Superannuation Contribution Tax (ESCT) or Fringe Benefit Tax (such as the private use of a car, low interest loan, etc.) are not counted. Neither are the tax credits (FTC, IWTC, IETC etc.).

Employee benefits are subject to their own tax regimes and, because they are of benefit to the employee, they are indirect forms of remuneration. In the past, employees tended to have little choice about this kind of remuneration. They were part of the terms and conditions of employment and employees simply participated on the basis that the employer decided.

That prescriptive approach tends not to be the case now. Non-cash, deferred benefits that are directly subsidised by the employer are less common. However, with the employer's cooperation, an employee can choose to forgo taxable pay in

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<sup>16</sup> Though sometimes capital receipts are deemed to be 'income' if they are received on a basis that will be applied for an "income-related purpose": paragraph f(xvi)c of the definition of 'income' in section 3(1) of the Social Security Act 1964.

exchange for a contribution by the employer of the same gross amount to a KiwiSaver scheme or to a 'registered superannuation scheme'. This is called 'salary sacrifice'.

A decision to sacrifice salary can therefore improve a family's net disposable income, depending both on income tax and on its entitlements under these different state-administered programmes.

An RPRC *Pension Briefing* (Retirement Policy and Research Centre, 2009b) illustrated how an employee with taxable pay of \$150,000 a year could reduce overall tax by \$5,080 a year. Taxable pay (that counts for income-related state payments) would be \$70,000 rather than \$150,000.

In an extreme 'salary sacrifice' case, further reductions are possible (in combination with the PIE regime) and the employee could even qualify for the Independent Earner Tax Credit (paragraph A2.2.5 above) or other state-provided benefits.

### **A2.5 'Effective marginal tax rates' (EMTRs)**

An individual's 'marginal tax rate' is the amount of income tax the individual will pay on the next dollar of income. As Table 1 shows, this can be 12.5%, 21%, 33% or 38%.

However, an employee's economic position must also take into account the effect that extra income has on state-mandated payments and levies.

Table 3 shows a necessarily abbreviated summary to illustrate the combined effect of the various types of tax/abatements.

**Table 3: Effective Marginal Tax Rate illustrations (one child family)**

	Income tax rates (Note 1)			
	12.5%	21%	33%	38%
Family Tax Credit, or In-work Tax Credit	n.a. (Note 2)	41%	53%	58%

**Or**

Independent Earner Tax Credit	n.a. (Note 3)	34%	n.a. (Note 4)	n.a. (Note 4)
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**Plus**

Student loan repayments (Note 5)	n.a. (Note 6)	10%	10%	10%
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**Plus**

Student Allowances (Note 7)	n.a. (Note 8)	n.a. (Note 8)	25%	25% (Note 8)
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**Plus**

Child Support (Note 9)	n.a.	18%	18%	18%
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**Notes:**

1. Taxable income is assumed to be received by one person in the household.
2. Abatement of the FTC and IWTC begins at taxable income of \$36,827 a year. If both are payable, the FTC abates first.
3. Abatement of the IETC begins at taxable income of \$44,000 a year.
4. Abatement of the IETC ceases at taxable income of \$48,000 a year.
5. Student loan repayments are capital and improve the earner's net wealth (though by reducing spendable pay).
6. Student loan repayments begin at taxable income of \$19,084 a year.
7. Based on a single student living in the parents' home – the amount is payable to the student.
8. Abatement of the Student Allowance begins at \$52,019 a year and ceases, in this case at \$78,418. For the sake of the example, the parent is assumed to be replacing the child's lost Student Allowance from after-tax income.
9. The 'living allowance' deducted from the 'liable parent's' income depends on personal circumstances. The Table assumes 'married; no dependent children'.

The ACC levy of 1.7% of taxable income to \$106,473 a year (2.0% from 1 April 2010) should also be added to all the rates in Table 4.

As explained in Appendix II, the regime is harsher still for those in receipt of a welfare payment like the Domestic Purposes Benefit. The abatement means that no DPB remains payable after \$27,389 of 'other' income.

The examples in Table 3 are necessarily constrained as adding income earners (another parent) or children can change the tax thresholds and the maximum income levels used for abatements. It also ignores a range of other potential state benefits, such as the Parental Tax Credit, the Accommodation Supplement and rest home subsidies.

Table 3 shows that the combined effects of tax and abatements (and Child Support, where relevant) can result in *effective* rates of tax/contribution of 69% for a notional 21% taxpayer who is an employee and to as much as 83% for a

38% taxpayer where a Student Allowance is being abated. Adding the ACC levy increases that to 70.7% and 84.7% respectively (71% and 85% from 1 April 2010).

The EMTR for someone who has been on a benefit like the Domestic Purposes Benefit will be 91% for a notional 21% taxpayer (plus the 1.7% ACC levy).

Table 4 shows how far up the income levels that two of the family-related, income-tested payments now reach.

**Table 4: Maximum income levels above which no benefit is payable<sup>17</sup>**

Number of children	Annual income (before tax)	
	Family Tax Credit	In-work Tax Credit
1	\$59,262	\$74,862
2	\$74,857	\$90,457
3	\$90,452	\$106,052
4	\$106,047	\$125,547
5	\$121,642	\$145,042
6	\$137,237	\$164,537

The Table 4 income levels are as of 1 October 2008 and assume all children are under age 13. Higher income levels apply for older, dependent children.

<sup>17</sup> Source Inland Revenue web site [www.ird.govt.nz](http://www.ird.govt.nz) [here](#).

### **A3: The way tax affects CIVs**

The most common way in which individuals indirectly receive 'income' is through the collective investment vehicles (CIVs) listed in paragraph A1.2 above. CIVs sometimes pay tax in their own right (and in different ways) and sometimes 'flow' income (and any tax deducted at source) to the CIV members. This paragraph A3 looks at two simple investments – an Australian share and an overseas bond. There are at least 11 different ways of owning the share and 13 different ways of owning the bond. Nearly all have different tax treatments.

#### **A3.1 Rationale for reform: reducing the effect of tax as an investment driver**

The last government set out to reform the tax treatment of both CIVs, like superannuation schemes, and also directly held international shares. One of the reasons given at the time for change was to even out the tax playing fields; to reduce or even remove tax as a reason for investing in a particular way. The 2005 *Discussion Document* stated:

“...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.....

“The proposals outlined in this discussion document aim to resolve these inconsistencies and the distorting effect they have on investor decision-making.” (Inland Revenue Department, 2005)

At the time, it seemed that one of the government's objectives was also to make the then new KiwiSaver more attractive for low income members; also to ensure that investment income earned through KiwiSaver did not affect income-related abatement regimes. KiwiSaver would be attracting many new savers and it was expected that a large proportion of them would have lower marginal tax rates. The then flat 33% tax rate that applied to the investment income of all superannuation schemes was seen as a potential barrier to convincing those savers to join.

The main results of the 2007 reform were the introduction of Portfolio Investment Entities (PIEs) and of the Fair Dividend Return (FDR) approach to the taxation of overseas shares.

When it comes to investing, the return that matters is the after-tax return. Fees and costs are also important. The after-tax return depends in part on the gross return of the investment and also on the way that the investment is bought/held. This paragraph A3 looks at the range of return outcomes that can arise simply because of the way the investment is bought for just two sample cases: an Australian share and an overseas bond.

It is clear that the tax regime is complex and distortionary and this seems at odds with the reasons for the 2007 changes. This can only be a general explanation and should not be construed as tax advice. It is now very important for investors to check with a tax expert before making any investment decision. That need also illustrates what is wrong with the current environment.

### A3.2 Investment options

Individual investors can invest directly, or through a product or pooled vehicle – a CIV. The CIV can be:

- a unit trust type of product, or
- a superannuation scheme type of product, or
- a 'portfolio investment entity' (PIE).

A **unit trust** type of product passes the return through to the investor and so the taxable income is ultimately taxed at the investor's own marginal tax rate. Examples are unit trusts, group investment funds (GIFs) and companies, where the dividends can have an 'imputation credit' attached to reflect the tax paid by the company. However, the ultimate tax liability rests with the shareholders.

By contrast, **superannuation scheme** type CIVs are taxed within the product and ultimately distribute the net return as tax-paid capital to the investor. Examples are registered superannuation schemes and insurance bonds. A superannuation scheme-type CIV is a 'final' taxpayer; no further tax liability can arise in the investor's personal tax return.

As long as the investor has supplied correct information, a CIV that is a **PIE** is also a final taxpayer and taxes the investment income within the PIE at the investor's marginal Prescribed Investor Rate (PIR). PIRs are currently either 19.5% or 30%. For the purposes of the analysis below, this is labelled 'PIR<sup>T</sup><sup>18</sup>'.

For more highly paid PIE members (those with taxable incomes of more than \$48,000 a year), the PIR will be a concessionary rate, that is, a lower rate of tax than would have applied had the PIE income been taxed in the member's hands.

PIE vehicles are also taxed for New Zealand and many Australian shares on only their dividends. Any capital gain is tax-free, even if that gain has resulted from trading profits. PIE vehicles can be unit trusts or superannuation schemes but there are rules that try to prevent small groups of individuals obtaining PIE-based concessions.

As a general principle, CIVs allow groups of savers to pool their savings with the goal of gaining the advantages of scale and flexibility.

One CIV can invest in another CIV of either the same type or a different type from the investor's own classification. That can therefore alter the overall tax basis. For example, a unit trust or superannuation scheme could invest in a PIE.

The jurisdiction of the CIV also influences the tax treatment. For example, an investor investing in a New Zealand unit trust that owns an Australian share receives a different tax treatment to that of an investor investing in an Australian unit trust that invests in the same Australian share. Overseas-based trusts (including those based in Australia) fall under the Fair Dividend Rate tax regime (FDR Regime).

In summary, the **FDR Regime** deems as income an amount equal to 5% of the asset's value at 1 April in the tax year. Tax at the investor's personal marginal rate is payable on that deemed income, regardless of either the dividends payable in that year or the movements in the capital value.

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<sup>18</sup> From 1 April 2010, the PIRs will become 12.5%, 21% and 30%. See Appendix I for a fuller definition of the complex PIE tax treatment.



In some cases (described below), the FDR Regime can be concessionary (requiring less tax to be paid than would have been the case had the income been earned directly). In other cases, the tax treatment could be penal. It is unlikely to be 'correct' when measured against the test of other investment income received directly by the investor. It would be correct only if the economic income (including capital gains) were exactly equal to 5% of the 1 April value.

### A3.3 Owning an Australian share

To illustrate the new complexities of the tax treatment of investing, the ownership of a single Australian share (BHP Billiton) is used as an example.

There are at least 11 different ways a New Zealand investor can invest in BHP Billiton shares under four broad categories of ownership:

- direct investment;
- unit trust style of investment;
- ownership through a registered superannuation scheme;
- ownership through a 'portfolio investment entity' (PIE).

With each of the 11 cases, the gross return from the share itself is the same, but the net-of-tax return to the New Zealand investor will be different, depending on the way in which it is owned.

In each of the examples, the gross return of the BHP Billiton share is the dividend (D) together with the market movement in the value of the share (M).

The following analyses the tax treatment of those 11 different ways (identified as Cases A-K below).

#### A3.3.1 Direct investment

- A. **Direct long-term passive investment.** If the investor buys BHP Billiton shares directly, the tax treatment is the capital/revenue regime<sup>19</sup>. Under this, if the shares are bought for the long-term, the investor pays tax on the dividends received and benefits from movement in the value of the shares tax-free. The tax rate applicable to the dividends is the investor's personal marginal tax rate ( $M^T$ ). If the investor has total taxable income above \$70,000 in a year, this is currently 38%.

$$\text{Return} = ((1 - M^T) \times D) + M$$

- B. **Direct active investment.** The investor can buy and sell BHP Billiton shares based on when the investor thinks they will go up and down in value. On this basis, tax is paid both on the dividends received (if any) and the realised gain/loss arising from the market movement. The tax rate is the investor's personal marginal tax rate.

$$\text{Return} = (1 - M^T) \times (D + M)^{20}$$

- C. **'Direct indirect' investments.** The investor can invest in an Australian unit trust that in turn buys BHP Billiton shares. This shifts the tax

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<sup>19</sup> And, for an Australian share, directly owned, not subject to the FDR Regime.

<sup>20</sup> The result can, of course, be a negative number (a loss for tax purposes) that can be offset against other income or carried forward.

calculation to the FDR regime. In this case, the investor pays tax at the personal marginal tax rate on a deemed 'income' equal to 5% of the value of the investments on 1 April (Value).

$$\text{Return} = D + M - (M^T \times (5\% \times \text{Value}))$$

A subset of this possibility is where the purchase price (or the Value, if purchased in an earlier year) of the investments is below \$50,000 and the *de minimus* rule applies. In this case, the tax liability is on the capital/revenue regime (case A above).

### **A3.3.2 Unit trust investments**

- D. **New Zealand unit trust.** If the investor buys units in a New Zealand unit trust which in turn invests in BHP Billiton, the investor pays tax on essentially the same basis as Case B above. However, while the capital movement and dividends remain within the trust, they are taxed at the trust's rate of 30%. Ultimately, they become distributions from the unit trust and the investor receives an associated imputation credit (including, if relevant, in respect of past years). In that case, the returns are taxed at the investor's marginal tax rate as income (as for Case B above).

$$\text{Return} = (1 - M^T) \times (D + M)$$

Because this option involves a product with different internal tax rates from the investor's own rate, there will be timing differences.

- E. **New Zealand unit trust into a PIE.** As an alternative to investing directly in BHP Billiton shares, the New Zealand unit trust could invest in a PIE. On this basis, the New Zealand unit trust temporarily gains the benefits of a PIE: no tax on capital gains and a PIR tax rate of 30%. However, the final tax liability on distribution to the investor is still at the investor's marginal tax rate.

$$\text{Return} = (1 - M^T) \times (D + M)$$

- F. **New Zealand unit trust into Australian unit trust.** As a further alternative, the New Zealand unit trust could invest in an Australian-based unit trust that in turn buys the BHP Billiton shares. The tax treatment for the New Zealand unit trust under this arrangement comes under the FDR regime. In this case, tax is calculated on 5% of the value of the BHP Billiton shares (i.e. the unit trust holding that will presumably reflect the value of the shares) on 1 April each year. A further tax liability arises if the New Zealand unit trust buys and sells units in the Australian unit trust (which in turn owns BHP Billiton shares) in the same year. While the taxable income to the New Zealand unit trust is limited to 5% of the opening value of the units, the tax rate ultimately paid by the investor will be the investor's marginal rate (as for Case D above).

$$\text{Return} = (1 - M^T) \times (D + M)$$

### **A3.3.3 Registered Superannuation Schemes**

- G. **New Zealand Registered Superannuation Scheme – passive.** If the investor invests in a superannuation scheme that is registered under the Superannuation Schemes Act 1989 (a Registered Superannuation Scheme) that buys BHP Billiton shares and holds the shares on capital account, tax

is paid by the scheme at 30% on just the dividends. The net dividends and capital movements are accumulated and do not form part of the investor's income. They effectively become capital or tax-paid returns. The 30% tax does not reflect any investors' personal tax rates (12.5%, 21%, 33% or 38%, as noted in paragraph A3.2 above).

$$\text{Return} = (70\% \times D) + M$$

- H. **New Zealand Registered Superannuation Scheme – active.** If the investor invests in a registered superannuation scheme that buys and sells BHP Billiton shares and does not hold the shares on capital account, tax is paid by the scheme at 30% on the total of the dividends and the capital movement. The net income, after the deduction of the 30% tax, becomes tax-paid capital. There is no flow through to the investor's personal tax calculation.

$$\text{Return} = 70\% \times (D + M)$$

- I. **New Zealand Registered Superannuation Scheme into Australian unit trust.** As an alternative to Case H, the New Zealand Registered Superannuation Scheme can invest in an Australian unit trust that in turn owns BHP Billiton shares. The tax liability now falls under the FDR regime. The taxable income of the New Zealand scheme is 5% of the value at 1 April (of the unit trust – that, as before, reflects the BHP value) which is taxed at 30%. The actual return after-tax therefore, becomes the dividends received plus/minus capital movement less 1.5% (i.e. 30% x 5%).

$$\text{Return} = (D + M) - 1.5\%$$

- J. **New Zealand Registered Superannuation Scheme into a PIE.** As an alternative to the New Zealand Registered Superannuation Scheme buying the BHP Billiton shares directly, it can invest in a PIE that owns the BHP Billiton shares. The taxable income becomes the PIE income (i.e. the dividends) and it is subject to tax at 30% within the PIE. The capital movement is not taxable.

$$\text{Return} = (70\% \times D) + M$$

#### **A3.3.4 PIEs**

- K. **PIE.** If the individual investor invests in a CIV that is a PIE and which buys BHP Billiton shares then, whether the PIE holds them on capital account or revenue account, the PIE pays tax at the investor's PIR just on the dividends received. There is no tax liability on the capital movement.

The investor's PIR rate is currently either 19.5% or 30% depending on the total of their taxable income and PIE income, in the previous two tax years. In simple terms, if the investor's taxable income was below \$38,000 in either of those two financial years (and the total of taxable income and PIE income was less than \$60,000), the investor will probably qualify for the 19.5% PIR rate<sup>21</sup>.

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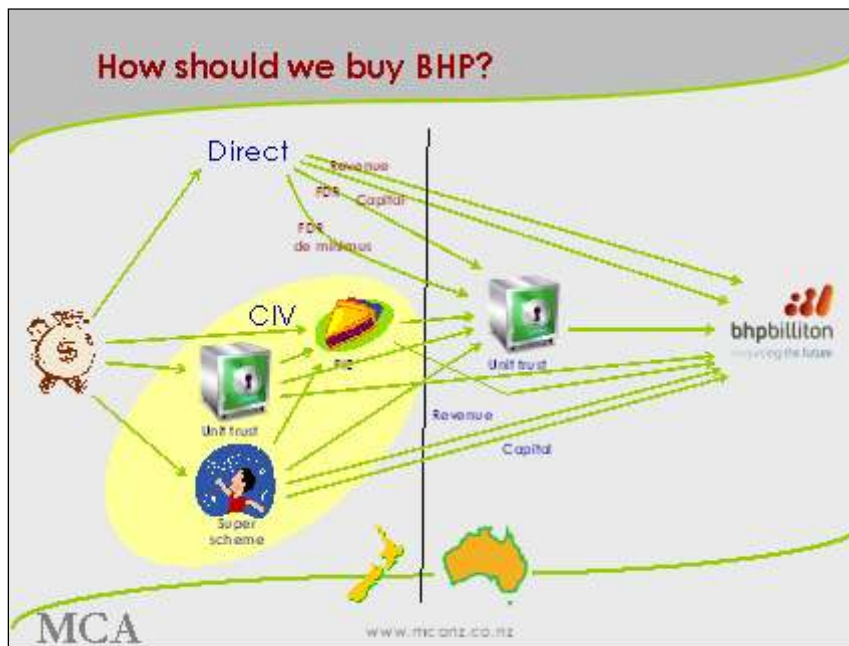
<sup>21</sup> See the Appendix I, paragraph AI.4 for more details on the relevant PIE definitions and the revised calculations/rates that apply from 1 April 2010.

The PIE tax is a final tax and there are no consequences to the investor provided the correct PIR has been specified. PIEs can be unit trusts, superannuation schemes, insurance bonds etc.

$$\text{Return} = ((1 - \text{PIR}^T) \times D) + M$$

The different tax treatments and structures can be illustrated in the following Chart 1.

**Chart 1: Illustrating the different ways of owning an Australian share**



### A3.3.5 The optimal strategy for Australian shares

The investor should be expected to maximise the after-tax return on the investment in BHP Billiton shares and to arrange that investment accordingly. For an individual, how that is done depends on the investor's marginal tax rate, *effective* marginal tax rate and issues such as costs, convenience etc.

For most, owning BHP Billiton shares through a PIE or through a superannuation scheme that invests in a PIE will be optimal. A unit trust is unlikely to be optimal unless the investor needs taxable income to offset against losses from other sources.

If the dividends of BHP Billiton are less than 5% p.a. then the PIE should own the shares directly. If the dividends are more than 5% p.a., the PIE should own them via an overseas-based vehicle to qualify for tax treatment under the FDR Regime. Historically, the dividends of BHP Billiton have been well below 5% p.a.. Therefore, owning the shares through a PIE or a superannuation scheme that invests in a PIE (for the higher paid) has the potential to result in the best New Zealand net-of-tax and net-of-fees return.

If the shares are not BHP Billiton shares but shares of a company that has had a dividend of more than 5% p.a., then the same structure makes sense but the vehicle should own the shares via an overseas-based unit trust to come under the FDR Regime.

Of the 11 different options A to K, four (B, D, E and F) have the same ultimate tax treatments but the patterns of net returns will differ depending on the relationship between the timings of dividends and market values relative to the 1 April fixing of 'Value' for the FDR Regime's calculations.

### **A3.3.6 Impact of currency management**

The above discussion ignores the impact of currency management. If currency hedging contracts are also bought to manage the currency risks, that changes the return pre- and post-tax. The optimal New Zealand vehicles are still the same but, in this case, there are also advantages in looking at an overseas based product that incorporates currency hedging contracts, as this falls under the FDR regime and can be more tax efficient.

### **A3.4 Owning an overseas bond**

There are more than 13 different ways a New Zealand investor can buy an overseas bond<sup>22</sup>, each with a potentially different tax treatment.

As with the Australian share (see paragraph 3.3 above), there are four basic ownership types: direct, unit trust, registered superannuation scheme and PIE. Compared with the 11 ways that potentially apply to the Australian share, the two additional ways of owning an overseas bond arise because of currency hedging. In almost all cases, investment in overseas bonds is hedged. The hedging arrangement can be within or outside the CIV.

In each case for the examples shown below, the gross return is assumed to be the same, but the net-of-tax return will be different, based on the way the bond is owned and hedged.

In the examples, the gross return of the overseas bond is the total of the interest from the coupon (I), the market movement (M) and the currency impact (C) or change in the New Zealand exchange rate.

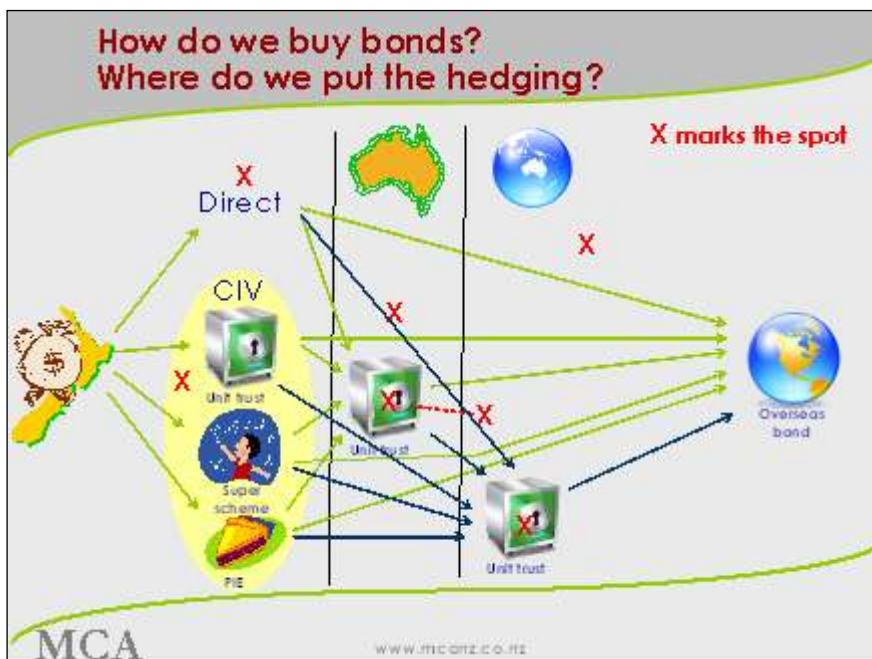
The different tax treatments and structures are described below (identified as Cases L to R).

Some of the differences arise from the location of the currency hedging arrangement. Chart 2 illustrates the options.

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<sup>22</sup> A bond is a fixed interest investment, such as government stock or corporate debentures.

**Chart 2: Illustrating the different ways of owning an international bond**



In each case, the 'X' in Chart 2 illustrates where the currency hedging contracts are placed, i.e. within the CIV or outside the CIV, in New Zealand, Australia or in another overseas jurisdiction.

Also, it must be remembered that when hedging because of tax, there will be times where the level of hedging should be equal to the value of the overseas bonds and times when it should be the value of the bonds divided by '1 less the marginal tax rate'. This effectively hedges the tax payable as well as the return itself. Because of the impact of interest rate differentials this will give a further variation to the net return outcomes.

### A3.4.1 Direct investment

- L. **Direct investment.** If the investor buys the overseas bonds directly, tax is payable under the accruals regime (over a *de minimis* threshold). This treats both interest received and any change in value as income (or losses). The tax rate applicable is the investor's personal marginal tax rate ( $M^T$ ). If the investor has total taxable income of more than \$70,000, that is currently 38%.

$$\text{Return} = (1 - M^T) \times (I + M + C)$$

- M. **'Direct indirect' investments.** The investor can use an Australian unit trust that in turn buys the overseas bonds. This shifts the tax treatment to the FDR Regime. Here the investor pays tax at the marginal personal rate on a deemed income equal to 5% of the value of their investments on 1 April.

The net return to the investor also depends on where the currency hedging is held. It can be held separately or within the CIV. If it is held in the CIV, the net return also depends on where the currency contracts are purchased i.e. in Australia or outside Australia. If purchased in Australia then there will be Australian tax ( $A^T$ ) to pay on the currency gains.

- (a) Hedge held directly by investor:  
 $\text{Return} = I + M + ((1 - M^T) \times C) - (M^T \times 5\%)$   
 or
- (b) Hedge held in Australia:  
 $\text{Return} = I + M + (1 - A^T) \times C - (M^T \times 5\%)$   
 or
- (c) Hedge held outside Australia:  
 $\text{Return} = I + M + C - (M^T \times 5\%)$

A subset of this is where the total cost price (or the Value at 1 April) of the taxpayer's investments is below \$50,000 and the *de minimus* rule applies. In this case, the tax liability is under the capital/revenue regime.

A further variation can occur when the overseas unit trust is not based in Australia or the Australian unit trust itself invests in an overseas unit trust. In these cases, the net return is one of the above returns though there may be some tax slippage within the overseas based unit trust.

#### **A3.4.2 Unit trust investments**

- N. **New Zealand unit trust.** If the investor buys units in a New Zealand unit trust which in turn invests in overseas bonds, the investor pays tax essentially on the same basis as under Case L above. However, while the returns remain within the trust, they are taxed at 30%. Ultimately, they become distributions from the unit trust and the investor receives an associated imputation credit including, where relevant, in respect of past years. When withdrawn, the returns are taxed at the investor's marginal tax rate as income.

$$\text{Return} = (1 - M^T) \times (I + M + C)$$

- O. **New Zealand unit trust in Australian unit trust.** As an alternative to investing directly in overseas bonds, the New Zealand unit trust could invest in an Australian-based unit trust or an overseas-based unit trust that in turn buys the overseas bonds. The tax treatment of the New Zealand unit trust under this arrangement comes under the FDR Regime. Tax is payable on 5% of the value of the overseas unit trust that will in turn reflect the value of the overseas bonds on 1 April each year.

A further tax liability arises if the New Zealand unit trust buys/sells units in the Australian/overseas unit trust (overseas bonds) in the same year. While the taxable income is limited to 5% of the value of the unit trust and therefore the overseas bonds, the tax rate ultimately paid will be the investor's marginal rate. Also, significant timing issues and tax slippage can occur depending on where the currency is managed. Ultimately the return becomes:

$$\text{Return} = (1 - M^T) \times (I + M + C)$$

#### **A3.4.3 Registered Superannuation Schemes**

- P. **New Zealand Registered Superannuation Scheme.** If the taxpayer invests in a New Zealand Registered Superannuation Scheme that buys overseas bonds, the tax treatment is the same as for Case L above but the

tax rate is now the 30% superannuation scheme rate. The 30% tax does not reflect any investor's actual personal tax rate.

$$\text{Return} = (1 - 30\%) \times (I + M + C)$$

Q. **New Zealand Registered Superannuation Scheme in an Australian unit trust.** As an alternative to Case P above, the New Zealand Registered Superannuation Scheme can invest in an Australian unit trust or an overseas unit trust that owns the overseas bonds. The tax liability falls under the FDR regime and the taxable income is now 5% of the value at 1 April and is taxed at 30%. In addition, the return will be influenced by where the currency contracts are held and bought: i.e. held in or outside the CIV and bought in Australia or overseas (outside Australia). The actual return after-tax therefore, becomes the gross return less 1.5% (i.e. 30% x 5%) adjusted for currency. The alternative formulae are:

(a) Hedging held directly by investor:  
Return =  $I + M + (1 - 30\%) \times C - 1.5\% \times \text{Value}$

Or

(b) Hedging held within product:  
Return =  $I + M + C - 1.5\% \times \text{Value}$

#### A3.4.4 PIEs

R. **PIE.** If the investor invests in a CIV that is a PIE and that buys overseas bonds, the PIE pays tax at the investor's PIR on the return. In essence, the return is the same as that of the Registered Superannuation Scheme (Case Q above) except the tax rate is not 30% but the investor's PIR tax rate. The alternative formulae are therefore:

$$\text{Return} = I + M + (1 - \text{PIR}^T) \times C - \text{PIR}^T \times 5\% \times \text{Value}$$

or

$$\text{Return} = I + M + C - \text{PIR}^T \times 5\% \times \text{Value}$$

#### A3.4.5 The optimal strategy for overseas bonds

For an individual, the 'best' answer for an investment in overseas bonds depends on the investor's marginal tax rate, *effective* marginal tax rate and issues such as costs, convenience etc. For most, owning overseas bonds through:

- a PIE or a Registered Superannuation Scheme that
- invests in an Australian/overseas unit trust and that
- incorporates the currency hedging purchased overseas

will probably be optimal. This limits the tax to either 30%, or the investor's PIR, on 5% of the value.

As the expected average return from hedged overseas bonds is above 5% p.a., this reduces the effective tax paid.

International, investment-grade corporate bonds currently yield about 8% a year (fully hedged)<sup>23</sup>. However, taxable income under the FDR regime is capped at 5%. At 30% (the top PIR rate and the rate applicable to Registered

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<sup>23</sup> Source: MCA NZ Limited.



Superannuation Schemes) the tax payable is actually 1.5%; that is, 30% of 5%. On that basis, the effective tax rate becomes 18.75% (1.5% tax on 8% income).

The tax treatment of any hedging contract adds another complexity. Gains under the contract are taxable under the accruals regime as it is a 'financial instrument'. Whether losses are claimable is unclear (and should not be). There is a possibility that losses can be carried forward against future taxable income but not offset against other income. The answer will depend on the combination of the FDR regime and the accruals regime; whether hedging is in or out of the product and whether the product is sourced from Australia or another country.

## **Part B: Tax is now an important influence in investment decisions**

The 2005 *Discussion Document* aimed to reduce the influence of income tax on investment decisions. Part B suggests that tax is even more important now that it was before 2005 and illustrates that with a look at Registered Superannuation Schemes.

### **B1 Tax should not drive the decision, but it does**

In theory, tax should not be the driver of the decision for the implementation of an investment. As already noted (paragraph A3.1 above), that was the aim of the government's 2005 *Discussion Document*. Unfortunately, as illustrated in paragraph A3, the tax structure now plays an even more significant role in the decision than in the past and the position will become more complicated with the introduction of the three tiered PIR regime (12.5%, 21% and 30%) from 1 April 2010.

The treatment of a CIV's investment income is not the only tax issue. The way in which amounts reach the CIV ('contributions') and amounts are eventually paid to members ('benefits') can also have tax implications.

Paragraphs B2 to B5 summarise, as an example, the way in which the income in relation to a member of a Registered Superannuation Scheme is taxed.

### **B2 Definition of investment income – Registered Superannuation Scheme**

There are broadly three different ways of calculating a Registered Superannuation Scheme's investment income, depending on the type of asset.

- Income from directly held cash or bonds is taxed under the accruals regime. 'Income' can include changes in the unrealised capital values.
- For New Zealand and most listed Australian shares, the answer will depend on whether the Registered Superannuation Scheme is a PIE: if it is, only dividends (not trading gains) are taxable income. For non-PIEs, the answer will depend on whether the scheme is holding the investment on capital account or is a 'trader'.
- For all other overseas shares (both PIEs and non-PIEs), the Registered Superannuation Scheme's income is based on the FDR Regime. This is an artificial concept that uses 5% of the year's opening value for each share, regardless of what actually happens to the share price and dividend during the year. It therefore bears no relationship to the economic income earned on whatever basis might apply to the scheme's assets.

The 'income' from directly owned property was unaffected by recent changes: rent is taxable income and gains may be 'income' on realisation if the asset has been held on income account.

### **B3 Tax treatment of investment income – Registered Superannuation Scheme**

How the Registered Superannuation Scheme's investment income is then taxed depends on what type of tax vehicle it is. A PIE must currently (to 31 March 2010) know whether a member has a 19.5% PIR. That depends on how much

taxable income the member earned in one of the two previous complete tax years.

If earned income has been less than \$38,000 (including directly earned investment income) and total income (including PIE income) was under \$60,000 (until 1 April 2010), the PIE income is taxed at only 19.5%. So, if a member's income comes only from PIEs, the member can have up to \$60,000 a year (\$120,000 for a couple – an 'all or nothing' test) taxed at only 19.5%. This is described in more detail in the AppendixI: paragraph AI.4.<sup>24</sup>.

For everyone else, including members of non-PIEs, the Registered Superannuation Scheme pays tax at 30% (the maximum rate), regardless of the member's marginal tax rate that could be 12.5%, 21%, 33% or 38%. Members whose marginal rates are either 33% or 38% pay less tax than would apply to directly earned income. Members whose marginal rate is 12.5% or 21% would currently pay more tax in respect of investment income earned through a non-PIE CIV than if received directly.

For the reasons explained in paragraph A2 above, income tax is not the final word on the net returns attributable to investment income for both groups of members because of the impact of income-tested state payments. The EMTR of a 21% taxpayer could be as high as 70.7%, allowing for the FTC/IWTC, student loan payments, child support payments and the ACC levy. A PIR of 19.5% in a PIE or a tax rate of 30% in a Registered Superannuation Scheme could therefore represent a significant effective advantage if income that would otherwise have been taxable, if received directly, were streamed through a CIV.

#### **B4 Tax treatment of contributions received by a Registered Superannuation Scheme**

The contributions by a **member** come from after-tax income on which the member has paid tax at 12.5%, 21%, 33 or 38% (plus the ACC levy). That has effectively been the tax treatment since 1988.

The tax treatment of contributions by **employers** is complex. If they are made to a KiwiSaver scheme or to a KiwiSaver look-alike called a 'complying fund', they are tax-free up to 2% of the member's pay (assuming that the employee is also saving 2% through the PAYE system).

If the employer's contributions are made to a non-KiwiSaver scheme, they are subject to Employer Superannuation Contribution Tax (ESCT) at either:

- a straight 33%, regardless of the member's taxable income, or
- a variable 12.5%, 21% or 33% depending on the actual taxable income the member earns from that employer in the current year (new employees and employees not employed for the full previous financial year) or in the last complete financial year (others). However, there is an allowance of 20% on top of the normal tax bands before the next higher tax rate applies.

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<sup>24</sup> From 1 April 2010, the income totals and appropriate PIRs become: (a) taxable income to \$14,000 and total income to \$48,000: 12.5%; (b) taxable income \$14,001 to \$48,000; total income to \$70,000: 21%; taxable income more than \$48,000; total income more than \$70,000: 30%. If the member's income comes only from PIEs, up to \$70,000 will be taxed at only 21%. That is less than the income tax that would have applied to that income, directly received. That would have been an average 23.1%. For income above \$70,000, the 30% PIR is a significant concession to the top marginal rate of 38%.

'Income' in this context includes the total employer contributions to KiwiSaver and to a Registered Superannuation Scheme.

If the employee has not worked for the full last financial year it is based on the employer's estimate of 'income' from that employer (i.e. excluding other employers) in the current financial year. The details are described in the Appendix at paragraph AI.3.

An employee can, with the employer's agreement turn otherwise taxable pay into an employer's contribution to a Registered Superannuation Scheme. This process, called 'salary sacrifice', lets employees take advantage of a usually reduced tax on those contributions under the ESCT regime (potentially nil in the KiwiSaver case).

Finally, KiwiSaver members are advantaged by the government's own contributions to KiwiSaver. The initial \$1,000 'Kick Start'; the annual 'member tax credit' of up to \$1,043 and the subsidy for first-home buyers (up to \$5,000 after five years) are all tax-free.

## **B5 Tax on benefits – Registered Superannuation Scheme**

Benefits from superannuation schemes are tax-exempt. They are still treated as withdrawals of tax-paid capital, even when tax subsidies have applied (as in the case of KiwiSaver contributions). That has been the position since 1990 and applies to both lump sum and pension benefits.

However, where an income-tested welfare benefit applies (see Appendix II below) pensions are 'income' despite their tax treatment as, effectively, tax-paid capital. If this type of income were treated on an 'in principle' basis, the underlying before-tax investment earnings received by the pension provider on the pensioner's notional capital should be 'income' but not the capital component of the pension. That is simply a return of the member's own money. Given that the welfare system ignores the accrual of entitlements before retirement when testing for income, it seems inconsistent to suddenly pay attention to a pension when the income starts<sup>25</sup>.

Even regular withdrawals of lump sums from a Registered Superannuation Scheme are 'income' for income-tested state benefits<sup>26</sup> if they are deemed to be taken for an "income-related purpose". Looking just at the amounts received is illogical. It would be more logical to 'look through' the scheme and take account of the underlying investment income that is attributable to the beneficiary. But, again, the welfare system does not do that before benefits emerge and does not even do that once benefit withdrawals start.

## **B6 "Investor decision-making"**

The tax playing field has now been tilted in favour of investing, and being paid, through a Registered Superannuation Scheme, including a PIE. Despite what the 2005 *Discussion Document* (Inland Revenue Department, 2005) said, investors' decisions will be affected by different tax treatments for income from investments that are fundamentally similar in nature. In summary, if the investment objective is to minimise tax and maximise other entitlements:

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<sup>25</sup> Where there is a cash-based asset test (such as for some welfare benefits), there is some logic to including the capital component. However, that should also apply to the accrual of entitlements where the benefits are accessible.

<sup>26</sup> As required by paragraph (f)(xvi)(C) of the definition of 'income' in section 3(1) of the Social Security Act 1964. Work & Income NZ's explanation of this is at [www.workandincome.govt.nz](http://www.workandincome.govt.nz) [here](#).

- Employees should receive pay through a Registered Superannuation Scheme<sup>27</sup> (particularly KiwiSaver), rather than as taxable pay. Superannuation contributions by 'salary sacrifice' also reduce the employee's income that counts for various income-related payments that are described in paragraph A2 above.
- All taxpayers should receive investment income indirectly through a CIV, particularly if it is a PIE, rather than directly<sup>28</sup>. The only exception will be someone who paid less than \$50,000 for directly invested overseas shares (\$100,000 for a couple). For them, the *de minimus* rule under the FDR Regime treats directly owned shares more favourably. Anything above the \$50,000 threshold - an 'all or nothing' test - should be held through either a Registered Superannuation Scheme or a PIE.

The PIE rules attempt to limit access to groups of at least 20 investors none of whom can hold more than 5% of the PIE's assets. However, even a small, 'closely held' superannuation scheme can invest in a PIE and allow the individual to capture directly the PIE advantage and limit tax on the rest. The separate scheme doesn't itself have to be a PIE - yet another complexity in the PIE landscape.

An RPRC *Pension Briefing* (Retirement Policy and Research Centre, 2009a) illustrated how a couple with \$5 million to invest could structure their investments and reduce overall tax by \$13,660 a year (with no reduction in flexibility), by comparison with directly held investments. For the purpose of calculating any income test in relation to state-provided (or administered) benefits, direct taxable income in the example referenced can be as much as \$250,000 or as little as \$28,000 a year.

## **B7 Score card after the 2007 changes**

The discontinuities between different parts of the CIV regime, the illogical tax treatment of contributions and investment income and the artificial distinctions between directly and indirectly earned income mean, inevitably, that the 2007 rules will be subject to change as advisers test the boundaries. As is usually the case, wealthier taxpayers will benefit the most as they rearrange their affairs to best tax advantage. They should capture the KiwiSaver-related concessions and invest the rest either in a PIE or in a superannuation scheme that invests in a PIE. They should not invest directly.

Along the way, the tax system seems to have lost the natural meaning of 'income'. In a progressive tax regime, how much total 'income' an individual receives matters to the system's integrity. 'Investment income' needs, potentially, to have no clear connection with the member's economic capacity to pay tax. If this basic principle had been set aside for practical considerations, that might have been justifiable. Regrettably, that was not the case.

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<sup>27</sup> Some similar considerations also apply to an unregistered superannuation scheme. The employer's contributions are taxed on a basis similar to direct pay but both that economic income and the investment income earned by the scheme do not count when income-tested state benefits are calculated.

<sup>28</sup> This will still be the case after 1 April 2010 when the new PIRs of 12.5% and 21% replace the current 19.5%. The tax payable on the investment income will not be more and may be less than if directly received. That is because of the way the income to set the PIR is calculated. See the Appendix I, paragraph AI.4 for more details.

New Zealand needs to question what has been achieved. The sense test was apparently missed at the time of the 2007 changes.

As the 2009 Tax Working Group put it:

“The tax system lacks coherence, integrity and fairness: Differences in tax rates and the treatment of entities provide opportunities to divert income and reduce tax liability. This disparity means investment decisions can be about minimising tax rather than the best business investment. For individuals, the tax burden is disproportionately borne by PAYE taxpayers since many with wealth can restructure their affairs through trusts and companies to shelter income from taxes or to enable people to receive social support.” (Tax Working Group, 2010, p. 9)

## **Part C: A more coherent regime for CIVs is possible**

Part C describes three fundamental principles (collectively dubbed the 'gold standard') against which the tax treatment of CIVs should be measured. It also examines the practical implications of those principles and how they affect the interaction of members and providers with both the income tax system and income-tested state payments and levies. Under the proposed regime, tax paid by CIVs would be imputed to members, significantly simplifying current rules. The TWG's 2010 report identified only some of the issues and avoided others.

### **C1 Magnifying inconsistencies – why CIVs' tax treatment matters**

Paragraph A1 of this paper summarised the way 'income' is defined for income tax. Some 'income' is disregarded in respect of the individual (in the progressive regime), not because of any difference in economic substance but because it has been earned indirectly. Sometimes it is treated separately for tax purposes.

The inconsistent treatment of 'income' for tax purposes is magnified when the state intervenes directly in 'income' as briefly described in paragraph A2 because the state usually uses the same definition of 'income' as the Inland Revenue uses when it taxes amounts in respect of individuals. When the state decides that people are not receiving what income they need or require other kinds of help, there is a complex system of income and benefit support. Again, as briefly summarised in paragraph A2, having given income-related help, the state then starts to take it away when, according to the rules, people do not need to be helped in that way so much, or at all.

Part A set the scene for the main theme of this report: the inconsistent way that 'income' is calculated and applied in CIVs and then how that CIV-derived income is treated in individuals' hands. Part B detailed how different vehicles for deriving investment income can affect the definition of an individual's 'income': sometimes including it; at other times excluding it and often treating the economic gains differently even within those two broad alternatives.

In principle, there seems little justification for all these differences particularly when account is taken of their impact on state entitlements.

### **C2 Tax and the level playing field – a suggested 'gold standard'**

The tax treatment of CIVs like Registered Superannuation Schemes needed reform before 2007 but not the changes that were made.

To achieve the apparent objective of reducing or eliminating tax as an influence on investment strategy should see investors making their decisions for other than tax reasons. If that were to be the objective, there are three broad principles that should apply to all CIVs:

#### **(a) Principle 1: Tax should not be the driver.**

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, PIEs, unit trusts, group investment funds, life insurance funds or companies.

#### **(b) Principle 2: Place of origin should not matter.**

For New Zealand tax purposes, it should not 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<sup>29</sup>.

**(c) Principle 3: The individual's circumstances are important.**

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. As the original 2005 *Discussion Document* stated, the investor should choose a CIV for reasons other than tax – for example, for convenience, cost, diversification, liquidity, management skills etc.

These principles may need tempering if the cost of collecting the 'correct' amount of tax were uneconomic. Any replacement compromise should, however, recognise the principles and the costs of change.

The three principles form a suggested 'gold standard' against which any proposals should be measured. The old tax regime that governed the different types of CIV violated all three principles. Regrettably, the current 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. The current regime does not come close to that objective.

**C3 More on the term 'gold standard'**

Explanations of the expression 'gold standard':

- The expression is not intended to convey any impression of quality. Here, the gold standard is a relative comparator; not an absolute measure. 'Income' as far as an individual is concerned, should not have different definitions when tax or income-tested benefits are discussed. An inadequate definition of 'income' might still qualify under the gold standard as long as it is applied consistently. Currently, the tax and income-tested benefit systems comprehensively fail that consistency standard.
- The gold standard is not a synonym for a comprehensive income tax though it is arguably a necessary step toward that and away from the current arrangements. A comprehensive income tax treats amounts received by a taxpayer from all sources (income, capital gains, legacies etc.) as 'income' for tax purposes because it improves the taxpayer's disposable income. Principle 3 of the suggested gold standard takes the tax system as it stands ('comprehensive' or not) so that, for example, if capital gains are not 'income' when received directly by the taxpayer, they should not be 'income' if received indirectly by the taxpayer through a CIV.

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 have failed to achieve these objectives and

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<sup>29</sup> The relationship between 'income' earned overseas, any tax paid overseas and the New Zealand tax regime will never be simple, especially where imputation credits are involved. The principle should be that New Zealand taxes the gross income and makes allowance for any tax already paid by the investor.



have left a complex patchwork of compromises and significant discontinuities between the income tax and welfare systems.

In recent years, there has been a concerted effort to reduce the number of taxpayers who are required to complete annual tax returns. The special place of CIVs could be seen as part of that process. However, maintaining the tax system's integrity requires the rate ultimately applied to the CIV's income to be as close as practicable to the investor's marginal rate. Once the additional demands of income-tested state benefits are factored into this process, it becomes almost impossible to ensure equity without some form of overall 'square-up' on an individual basis. This is a necessary consequence of a progressive income tax system and income-tested assistance.

The recommended process need not require an annual written return from the taxpayer. The Inland Revenue will have (or can easily obtain) all the information required. Only the Inland Revenue will know an individual's full position.

#### **C4 How might the gold standard have changed things?**

If the general principles of the gold standard had driven the reform of the tax treatment of CIVs in 2007, the following would have been likely outcomes:

**C4.1 Single tax treatment:** All CIVs would be subject to a single tax treatment. The current 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 and cannot calculate the final liability. The only body that has all the information about the taxpayer is the Inland Revenue: only it can calculate the final liability fairly.

**C4.2 Non-taxable or investor with tax losses:** If the investor doesn't pay tax (say, because it is a charity) or is an individual with tax losses, the tax paid on their behalf by the CIV should be recoverable.

**C4.3 Correct tax; each tax year:** For taxpayers with losses, the tax administration system should calculate the correct amount of tax each year, rather than have it based on an artificial construct that is driven by administrative convenience, such as the current test for PIEs of taxable income in one of the two last financial years. That artificial construct is not based on principles such as 'what is income?'; 'how much income was there in the year in question?'.

**C4.4 Overseas CIVs:** For an overseas CIV, 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 from New Zealand by the investor, then tax should be payable in that year on the individual's income in the CIV. It may be difficult, in some cases, to fix an individual's share of the income. That may justify some form of *de minimis* exemption but a principles-based approach of the kind described next may be easier to administer.

**C4.5 What is 'income'?** Defining 'income' is an area in which a prescriptive approach of any kind (especially the FDR regime) will create problems. It is unsatisfactory to leave this matter to statute and the courts (the approach to date). The international investment environment is too diverse to legislate in a way that can capture all the possibilities.

New Zealand law should instead state the principle and then specify a list of considerations that the Commissioner of Inland Revenue 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.

For example, when deciding whether a taxpayer is a 'trader' and liable for tax on realisation gains, the legislated criteria might include the period for which the assets were held; whether 'intention' can be inferred from conditions that applied at purchase such as the amount of debt used in the acquisition; whether the owner has a history of buying and selling; whether the trading pattern was part of a pre-published 'passive' strategy, the annual rate of portfolio turnover, market events such as mergers and takeovers etc.

Having stated the general rule and incorporated some general principles in legislation, the detailed and practical application of those rules would be left to the Inland Revenue's practice notes. These practice notes could even be as detailed as specifying which particular products qualify as 'traders' and which do not. Or they 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 represented that incorrectly, gaps could still be fixed at an individual investor level by imputation (more on that below). This therefore would be almost a self-regulating regime. There could even be an assumption that any CIV is a 'trader' unless the Inland Revenue has ruled otherwise. For most overseas CIVs, that is more likely to be right than wrong.

There seems no justification for a 'trader' to avoid tax on trading gains, as with PIEs that trade New Zealand and some Australian shares.

**C4.6 Continuous compliance:** Compliance with the suggested practice notes would be a continuous requirement. This would let the Inland Revenue be more flexible about its initial rulings because there would be less at stake in that initial process. Under this regime, the complexity and cost involved with obtaining 'binding rulings' could be replaced with a much less formal process. Loosening up this procedure should increase innovation, lower costs and make individual investors more aware of what they were buying. This would improve the investing environment in a way that is not possible under a 'black letter law' regime, such as New Zealand has now. 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 should matter. The suggested 'gold standard' will let the Inland Revenue keep that substance under continuous review and change its mind if it thinks that the substance has turned out to be different from the initial appearance. For that reason, it should not be legally bound by past practice notes; nor from the financial consequences to investors or scheme promoters of changing those.

The role of tax advisers and financial planners will be reduced under the recommended regime. That will reduce providers' costs and, through competition and disclosure, should improve net returns to investors.

**C4.7 Employer contributions:** Contributions by an employer to a Registered Superannuation Scheme should be part of the employee's income for tax

purposes. That is as it should be: it is income from employment, albeit deferred. So-called 'salary sacrifice' arrangements would then disappear. So would the artificial rules about ESCT and Fund Withdrawal Tax. These rules are now so complicated that few employers and financial service providers will be complying with their detail. Apart from anything else, most superannuation scheme administrators do not have all the information they need to comply with the current rules<sup>30</sup>.

Where the employer's contributions are 'unallocated' (as in a 'defined benefit' scheme), some form of accruals-based valuation will be needed to calculate the net improvement in the asset that is attributable to the employer's contributions. In New Zealand, that is a diminishing issue. Based on official reports for 2009, there were only about 100,000 Defined Benefit members (including pensioners) of private schemes, the Government Superannuation Fund and the National Provident Fund out of a total membership of about 650,000 (not counting KiwiSaver members).

## **C5 CIV's are useful for savers**

CIVs should be encouraged (though not necessarily tax-subsidised like KiwiSaver schemes). Their continued development should be seen as a positive contribution to a successful financial services industry. CIVs perform a number of positive roles for New Zealand's economy at a macro and a micro level.

The New Zealand regulatory regime should neither advantage or disadvantage investors but should leave individuals to use either CIVs or direct investments for the best reason of all: that it suits their circumstances, not that tax, or the impact on state-provided benefits, drives the decision. That is what the 2005 *Discussion Document* said was the basis for the proposed changes.

We suggest, however, that the outcomes have failed the Inland Revenue's own objectives. CIVs are now being established in particular ways specifically for tax and state benefit-derived reasons<sup>31</sup>. Arbitrary lines have been drawn between CIVs that are PIEs and those that are not. Individuals are setting up CIVs to re-define 'income' to minimise tax. Employees (particularly the higher paid) are restructuring remuneration to either reduce tax or to maximise entitlements under income-tested, state-provided benefits. As the Tax Working Group said:

"There has...been a growing incoherence in the tax rates applying to portfolio investment entities (PIEs) and other savings entities relative to those imposed on income earned by individuals." (Tax Working Group, 2010, p. 17)

## **C6 Practical implications for CIVs of the 'gold standard'**

No member of a CIV presently pays the appropriate tax on their full income (both directly and indirectly earned) under New Zealand's progressive tax regime. That distortion is potentially magnified when the tax system is set alongside the

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<sup>30</sup> For example, to calculate FWT correctly, the scheme administrator must know what the full taxable income of a departing member was in the four complete tax years before leaving (not just income from the employer with the scheme but also from other and past jobs). The paying scheme's administrator also needs to know the total of all employer superannuation contributions (other than KiwiSaver contributions) paid in the four complete tax years before leaving. FWT is also, inexplicably, due on benefits payable at the scheme's 'normal' retirement age. Most schemes probably do not comply with this requirement. Details are in Appendix I at paragraph AI.5.

<sup>31</sup> PIEs that are essentially term deposit bank accounts have been set up by many trading banks and finance companies for higher rate taxpayers.

income-related aspects of our welfare system as explained in paragraph A2 above.

The current system falls short of the 'gold standard' in the following ways:

- **Unfair:** Accepting the principle of a progressive tax system, the CIV regime lets the better-off pay less tax than a properly progressive system implies they should. It also potentially qualifies them for state-provided benefits that were not intended.
- **Erosion of the tax base:** Over time, a greater use of tax-driven structures will mean a loss of revenue. Average tax rates on directly earned income will have to be higher for all in order to collect the same revenue.

Here are specific areas in which fundamental principles are distorted:

**C6.1 Benefits in kind:** The remuneration that an employer delivers by contributing to a superannuation scheme should be part of the employee's taxable pay. Also, benefits subject to the Fringe Benefit Tax regime are 'pay' and should be part of the *employee's* income (not a benefit on which the *employer* pays tax). The employer's contributions to KiwiSaver should not be tax-free and should be added to other income the employee receives from all other sources, including CIVs.

**C6.2 Income tests:** State entitlements should all be abated against total income, including that derived from CIV membership. That does not happen now and, in recent years, the avenues for disguising 'income' have increased.

**C6.3 Private obligations:** If a parent has an obligation to maintain children or pay maintenance to a former partner, all 'income' should count. The liable parent should not be able to hide income through indirect pay or CIV-derived investment income.

**C6.4 Trading gains:** If someone (including a CIV) buys an asset with the intention of reselling it for a profit, the whole difference should be income and taxed in the year of receipt. That is a basic principle of current tax rules. The exemption for PIEs on trading gains in New Zealand and some Australian shares is unjustified and is an inexplicable distortion of the tax system.

## **C7 Abandoning proxy tax rates**

Adopting the suggested 'gold standard' would eliminate the need for proxy measures of the investor's tax rate. The Prescribed Investor Rate (PIR) for PIEs (currently either 19.5% or 30%; soon to be 12.5%, 21% and 30%), the ESCT and its companion Fund Withdrawal Tax (FWT) and Fringe Benefit Tax will all no longer be needed. That is because the amounts paid by the employer will be added to the employee's ordinary income and taxed in the usual way. As already mentioned, this will also mean the end of 'salary sacrifice'.

## **C8 CIVs pay a 'down-payment' on the member's tax liability**

CIVs should pay tax but only as a 'down-payment' for the liability the member will eventually meet in respect of that piece of income when everything is summed. As with imputation on company dividends and interest earned from bank accounts, the tax paid will carry forward to the final, complete calculation

for the year. That is easier to describe than to implement: the administrative issues would not be as complex as those created for CIVs by PIEs and PIRs and soon to be compounded by the introduction of yet more PIR rates and, presumably, more rules that CIVs will have to comply with.

The present income tax administration system seems to cope with the millions of bank accounts that operate on a basis that is similar to the way the suggested 'gold standard' regime would apply to all CIVs. There seems no reason why the bank account-based model cannot be adapted for CIVs. Technology now makes that a much less daunting task.

Only the Inland Revenue has access to all the information needed to calculate a taxpayer's 'proper' tax liability in respect of all 'income' and consequent entitlements to state benefits, often also administered by Inland Revenue itself. The 2007 changes, including the introduction of PIEs, seemed influenced by the Inland Revenue's wish to reduce as far as practicable the number of individuals who are required to file tax returns. In principle, that is a sensible objective.

The suggested 'gold standard' regime still would not require earners to file written returns. The Inland Revenue is already receiving most of the information it would need to calculate an individual's total tax liability (and benefit entitlements) if all directly and indirectly earned income were to be aggregated. The actual calculation might be a new process but the taxpayer need not be involved directly. Refunding overpayments of tax is not difficult administratively but collecting underpayments might need new powers, including the right to request a CIV provider to pay the money on the member's behalf.

That complexity could be avoided if the CIV deducted tax at the top personal marginal rate of, currently, 38% for all members/investors and leave the Inland Revenue to refund any overpayments with the annual consolidation. That may involve a relatively small timing cost for members/investors but would be simpler and less expensive to administer.

## **C9 Report of the Tax Working Group**

The 2010 Tax Working Group looked at a number of potential changes to New Zealand's income tax arrangements that are relevant to the issues covered here:

### **C9.1 Aligned top rates:**

If the top tax rates of 38% (personal income), 33% (trusts) and 30% (companies, PIEs and superannuation schemes) were aligned to a common rate, that would reduce the effect of some, but not all of the issues covered in this report. However, the Tax Working Group did not directly recommend that the top rates should be aligned (but stated that as its preference at page 66) and, if they were not, it did recommend (page 55) that the current maximum rate for PIEs of 30% (and other "widely held saving vehicles") should be removed. That would address part of the problem associated with CIVs but would still allow investors considerable flexibility. The report assumes the only issue with CIVs relates to members that would otherwise have paid tax at 33% or 38%. This report has shown that the misalignment of the top tax rates is only one difficulty caused by the way 'income' is defined under the current tax regime.

### **C9.2 High EMTRs associated with Working for Families:**

The report noted the high effective marginal tax rates (EMTRs) associated with the abatement regime under Working for Families described in paragraph A2 above. That covers the elements noted in paragraphs

A2.1.1 (FTC) and A2.1.2 (IWTC) but not those described in paragraphs A2.1.5 (IETC), A2.1.6 (student loans), A2.1.7 (student allowances) and A2.1.8 (child support payments). Nor does it address the more extensive issue described in Appendix II (abatement regime under welfare benefits like the Domestic Purposes Benefit).

The Tax Working Group did not note the exemption enjoyed by PIEs on trading gains in New Zealand and some Australian shares as a current distortion. Nor did it address the significant complexity and compliance issues associated with the different ways that investments can be made (described in paragraph A3 above).

### **C10 Looking at the whole issue**

The Tax Working Group said it was not its job to redesign the welfare system.

“Examining the social welfare system is outside the scope of the TWG.” (Tax Working Group, 2010, p. 55)

This paper suggests that the combination of income tax, income support and the treatment of CIVs leaves an unsatisfactory gap that now needs to be filled.

It is not possible to distinguish, in policy substance, between:

- income tax (where the state takes money);
- income-support (where the state gives back some of that money in different ways to people it decides need that support) and
- income-testing (where the state takes back part or all of the income support).

Those three strands go to make up the single environment of defining and calculating 'income'. Only in that context can the significance of CIV-derived income be measured and the problems identified and addressed. The reason that CIVs are adding to the inconsistencies derives from the 'silo approach' to tax policy that has treated some CIVs in isolation. This paper illustrates why that approach must change.

'Income' for all purposes should be defined consistently, no matter how it has been earned.

## **Part D Conclusion**

The tax system has been designed in regulatory silos. Each part of the system has little connection to the others; and the whole tax system has only passing links with state-provided, income-tested payments. The whole framework needs reform.

### **D1 Current system incoherent**

The 2007 tax legislation took more than 110 pages to prescribe the new rules for PIEs and the new FDR regime. The, in principle, unsupportable concessions and artificial boundaries necessitate intricately detailed definition and regulation. Boundary issues not envisaged by the 2007 rule-makers have since emerged and there will be more of those.

It now matters to individuals how they are paid (through a mix of direct pay, PIEs that are both KiwiSaver and non-KiwiSaver schemes, non-PIE Registered Superannuation Schemes and even unregistered schemes) and how they earn their investment income (through a different mix of those CIVs). For tax purposes, there are now four different types of superannuation scheme. Tax planners may welcome such diversity but it seems not to be progress as far as tax equity is concerned.

### **D2 The 2005 Discussion Document's failed aim**

The original *Discussion Document's* objective has not been achieved. New Zealand needs to return to a full discussion on levelling the tax playing field, both between different CIVs and then between CIVs and investors, while at the same time reducing the regulatory costs of intermediation.

### **D3 Two alternative approaches to 'income'**

The two possible approaches described in this paper can be summarised by answering the following question:

**(a) 'Final' taxpayers:** Are CIVs taxpayers in their own right, where the tax paid by the CIV is a final payment, regardless of the position of individual members/investors? That is the case now with superannuation schemes and also largely for PIEs<sup>32</sup>.

or

**(b) Collective vehicles:** Are CIVs collective vehicles that receive taxable income on behalf of their investors/members but where the final liability for tax lies at the individual level? This is similar to the present position for unit trusts and bank accounts that are not PIEs.

This paper suggests that the second 'collective' approach should be preferred mainly because it can satisfy the three requirements of the 'gold standard' test described in paragraph C2 above.

### **D4 Tax system illogical, inconsistent, complex and unfair**

The present tax regime in New Zealand is now illogical, inconsistent, complex and unfair. Not only is the tax system itself flawed and complex but also its

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<sup>32</sup> If the PIE investor has advised a 19.5% PIR when it should be 30%, the IRD has the right to revise the PIE's tax calculation.

interaction with state-provided, income-tested payments means that people are can receive amounts when it was surely never intended that they should. The way income tax has developed over the last ten years has a direct impact on the cost of the other parts of the system of income-support payments by the state but it seems that this is only now being noticed.

New Zealand now has a tax system that has been designed in regulatory 'silos'. Individual tax issues affecting pay, income, fringe benefits and superannuation have all been resolved without regard for their interaction or their individual or aggregate relationship with income-tested, state-provided (or administered) payments.

In addition, KiwiSaver schemes have specific tax subsidies that, along with the problems presented by all superannuation schemes, suffer the difficulties of all such subsidies. They are regressive, unfair, expensive, complex and probably do not work (increase saving).

#### **D5 Tax Working Group's approach inadequate**

These current deficiencies can and should be fixed but that requires a wider brief than the Tax Working Group was given.

The tax and welfare systems are so intertwined as far as individual taxpayers are concerned that it seems impractical to review, or change, one without at the same time assessing its impact on the other.

#### **D6 All 'income' should be taxed at the appropriate rate**

This report recommends that everything which looks like 'income' should be taxed as income at the appropriate marginal tax rate. The main way that 'income' earned collectively should be attributed to individuals is by imputation.

If state entitlements depend on 'income', all income needs to be counted, no matter how it is received and, in fact, whether or not that 'income' ends up directly in the hands of the recipient of the state-provided payment.

If state entitlements are withdrawn because the recipient's 'income' assumes the support is no longer needed then again, all income should count.

None of this happens now. The current inconsistent treatment of income creates arbitrary distinctions. Increasingly complex regulation will not address the problem, but the recommendations for consistent treatment made in this report would result in a fairer and more coherent system.



## Appendix I

### The present tax situation in brief

**AI** An individual faces a number of potentially different tax rates on an extra dollar of investment income. Those rates depend principally on whether the individual receives the income directly or indirectly and then also depends on the vehicle through which that income has been earned. The main possibilities are:

#### AI.1 Earnings for income tax

Ordinary income tax is payable on direct cash remuneration and other directly received income. This Appendix calls this the individual's "Taxable Earnings".

The tax to be paid accumulates by income band as follows:

**Table 5: Tax on earnings**

<b>Taxable Earnings</b>	<b>% tax on this band</b>
0 to \$14,000	12.5%
\$14,001 to \$48,000	21%
\$48,001 to \$70,000	33%
\$70,001 and over	38%

**Notes:** ACC premiums for both employee and employer are based on Taxable Earnings paid directly by the employer. The permanent disability ACC pension is also based on this. Details are as at 1 April 2009.

An extra dollar of investment income received directly by the individual is therefore taxed at the appropriate marginal rate.

When considering any test of 'income' associated with the payment of any state entitlements (see sub-paragraph AI.2 below), it is usually the individual's (or the household's) Taxable Earnings that count.

#### AI.2 Fringe Benefit Tax

The 'silo approach' to the taxation of an employee's income from employment is illustrated as follows: If an employee receives non-cash benefits (like a car, a low interest loan, or subsidised or free accommodation), the annual value of that is added to direct cash remuneration for the calculation of Fringe Benefit Tax (FBT). The grossed up equivalent of the tax that would have been paid by the employee is payable by the employer (plus GST, where applicable). The employee pays no tax directly as it is not income earned directly by the employee.

With respect to the fringe benefit itself, the correct amount of tax may have been collected; but because Taxable Earnings are used elsewhere for the calculation of state-provided benefits (see sub-paragraph AII below), where fringe benefits apply, the Taxable Earnings understate the true income the employee receives.

### AI.3 Employer Superannuation Contribution Tax (ESCT)

Where an additional dollar of an employee's remuneration is earned by way of an employer contribution to a superannuation scheme, tax is usually payable by the employer, again as a proxy for the employee, on those contributions. The calculation of Employer Superannuation Contribution Tax (ESCT) depends on:

- (i) the total of Taxable Earnings paid just by the employer (not including Taxable Earnings paid by another employer), plus
- (ii) contributions paid just by the employer to Registered Superannuation Schemes in respect of the employee, plus
- (iii) employer contributions to KiwiSaver that exceed the tax-free limit; this limit is an amount that matches the employee's own KiwiSaver contributions but with a maximum of 2% of the Taxable Earnings paid just by the employer.

It does not include employer contributions to what the Income Tax Act calls a "superannuation scheme"<sup>33</sup>. Those are subject to FBT (as in sub-paragraph AI.2 above).

In Table 6 below, the amount that is subject to ESCT as in paragraphs (i) to (iii) above is called the "Total of Relevant Amounts".

The ESCT rate is as follows:

**Table 6: ESCT rates**

Total of Relevant Amounts	ESCT rate
0 to \$16,800	12.5%
\$16,801 to \$57,600	21%
\$57,601 and over	33%

The employer can elect to pay an alternative flat rate of ESCT that is 33% on all affected contributions.

In all cases, the ESCT rates are applied to the gross contribution. The net post-ESCT value is the amount actually received by the scheme.

The ESCT is not cumulative as is the case with income tax. The ESCT is *not* 12.5% on the first \$16,800, 21% on the next \$40,799 and 33% on the balance. So, for example, if the employer's contributions mean that the Total of Relevant Amounts is \$57,601, ESCT becomes 33% of all employer contributions (including the contributions in the Total Relevant Earnings that are below \$57,601). However for KiwiSaver on its own, the exemption is

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<sup>33</sup> The Income Tax Act 2004 confusingly calls a scheme that is registered under the Superannuation Schemes Act a "superannuation fund" while an unregistered scheme is called a "superannuation scheme".

allowed to the maximum with only the excess taxed as for other employer contributions.

The employer is effectively paying the ESCT on the employee's behalf (as a 'proxy'). Whether or not the ESCT paid fairly reflects the income tax the employee would have paid had the contribution been part of income (it will often be less) the employee's total remuneration is not counted in the calculation of state-provided benefits (see paragraph AII below).

**AI.4 For PIE income**

The tax currently payable by a PIE in respect of a member depends on the total income in a financial year (ending on a 31 March) of the member's "Taxable + PIE Income". This is:

- (i) the member's PAYE earnings in the year, plus
- (ii) other taxable income received by the member (interest, dividends, rent etc), plus
- (iii) the total before-tax PIE income (reduced by any PIE losses)<sup>34</sup> attributed to the member in that year by the particular PIE and by any other PIE the member belongs to.

The member must advise the PIE whether the PIE tax rate for a year (the "Prescribed Investor Rate" or PIR) should be either 19.5% or 30% as shown in Table 7.

**Table 7: PIE tax rates**

<b>Taxable income</b>	<b>Taxable + PIE Income</b>	<b>PIE tax rate (PIR)</b>
To \$38,000 - <b>and</b>	0 to \$60,000	19.5%
\$38,001 - <b>or</b>	\$60,001 and over	30.0%

**Notes:**

1. The PIE tax rate is, like ESCT (sub-paragraph AI.3 above), an 'all or nothing' test. If either the Taxable + PIE Income exceeds \$60,000, or the total of the member's PAYE Earnings and other directly received taxable income exceeds \$38,000 in that year, the PIE tax rate must be 30%. Both of the tests must be satisfied for the lower 19.5% rate to apply.
2. The Taxable + PIE Income includes "portfolio investor allocated income" (less losses) from all PIEs but does not include income from collective investment vehicles that are not PIEs but that are 'final' taxpayers. Examples of these include a Registered Superannuation Scheme or an unregistered "superannuation scheme", as defined in the Income Tax Act 2007.

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<sup>34</sup> The Income Tax Act 2007 refers to these as the "portfolio investor allocated income" and the "portfolio investor allocated loss".

3. From 1 April 2010, the income levels and PIRs change as shown in Table 8:

**Table 8 –PIE tax rates from 1 April 2010**

<b>Taxable income</b>	<b>Taxable + PIE Income</b>	<b>PIE tax rate (PIR)</b>
To \$14,000 - <b>and</b>	0 to \$48,000	12.5%
\$14,001 to \$48,000 - <b>and</b>	To \$70,000	21.0%
\$48,001 and above - <b>or</b>	\$70,001 and over	30.0%

The 'year' to which these tests apply is also not straightforward – it applies only to complete financial years ending 31 March. If the test is satisfied in either of the last two financial years, the present lower PIE tax rate of 19.5% applies in the current year, regardless of either PIE income or taxable income in either the other of the two years or the current year.

The PIE must comply with the member's election as to the PIE tax rate but the Inland Revenue has the power to change the effect of that election if the member was wrong.

The PIE is again effectively paying the tax on the member's behalf (as a 'proxy'). Whether or not the PIE tax rate fairly reflects the income tax the member would have paid had the PIE income been part of 'ordinary' taxable income (it will usually be less) the member's total taxable income is not counted in the calculation of income tests for state-provided benefits (see sub-paragraph A.I.2 below).

#### **AI.5 For calculating Fund Withdrawal Tax (FWT)**

FWT of 5% is due on the payment of a benefit by an employer-sponsored, Registered Superannuation Scheme. The rules for this are complex and there are exemptions but the 'income' that triggers the potential FWT liability is as follows:

Taxable Earnings, as in sub-paragraph AI.1 above and including other taxable income **plus** all the employer's contributions paid to any Registered Superannuation Scheme by any of the member's current employers (including previous employers) in the current year and during the four preceding financial years.

For present purposes, this is the employee's "FWT Total".

The 'contributions' for this purpose do not include the employer's contributions to a KiwiSaver scheme, including those in excess of the compulsory 2% of PAYE earnings as a "permitted withdrawal from a KiwiSaver scheme or a complying superannuation fund" is exempt<sup>35</sup>. That also applies to an employer's contributions to an unregistered "superannuation scheme" as they have been subject to the FBT regime for contributions (paragraph AI.2) above).

<sup>35</sup> Section CS 10B of the Income Tax Act 2007.

If the FWT Total is less than \$70,000 in each of the four included years, no FWT is payable. The potential FWT liability is reduced by 25% for each complete year that the FWT Total is less than \$70,000.

**AII. Interaction with state benefits**

The net value to a saver of an extra dollar of investment income is affected by the way in which it has been earned, and by the interaction between that 'income' and benefits delivered by the state.

The entitlements to a number of state-provided benefits or obligations depend in some way on 'income'. These include:

- (i) Family Tax Credit;
- (ii) In-Work Tax Credit;
- (iii) Minimum Family Tax Credit;
- (iv) Parental Tax Credit;
- (v) Independent Earner Tax Credit;
- (vi) Student Loan payments;
- (vii) Student Allowances;
- (viii) Child support and maintenance payments;
- (ix) ACC levies;
- (x) ACC's income-related benefits.

In each case, it is the earner's Taxable Earnings (as per paragraph AI.1 above) that count (in some cases, the household's Taxable Earnings). To the extent that 'income' is either sheltered in vehicles that are 'final' taxpayers, or that does not count as Taxable Earnings (such as the fringe benefits described in sub-paragraph AI.2 above), the individual may both reduce tax and increase state entitlements.

## Appendix II

### State-provided welfare benefits

The state pays a number of income-tested welfare benefits. These include the Domestic Purposes Benefit, Unemployment Benefit, Sickness Benefit and Invalid's Benefit. These are all income-tested for relatively low levels of taxable income and in respect of the total income of the beneficiary and any spouse/partner.

For example, the Domestic Purposes Benefit<sup>36</sup>, payable to a sole parent with the care of a child under age 18, is calculated as follows:

- in respect of the parent: \$16,443 a year, before tax;
- in respect of the children, the Family Tax Credit (see paragraph A2.2.1 above) may be payable.

The parent may earn other income, including income from part-time, temporary or seasonal work. Up to \$4,160 a year (before tax) will generally not affect the benefits payable.

Table 10 shows the full income abatement rates for both the Domestic Purposes benefit and the Invalid's benefit<sup>37</sup>.

**Table 10: Income abatement for Domestic Purposes & Invalid's Benefits**

If yearly income before tax is...	The net benefit reduction is
Up to \$4,160	No reduction in benefit
\$4,161-\$9,360	30% of each \$1 of gross income
\$9,361 or more	70% of each \$1 of gross income

An additional \$1,040 can be added to each of these thresholds if the parent must pay for childcare as a consequence of working.

The abatement rate differs for the Unemployment and Sickness Benefits. It is a two, rather than a three step process: the full 70% abatement rate applying from \$4,160 a year.

A number of other welfare payments may also be relevant: the accommodation supplement (where the abatement rate is 25%) rest home subsidies (abatement rate is 100% against assets over a minimum and also against income), home help (for multiple births), childcare subsidies and the Out of School Care and Recreation (OSCAR) subsidy.

<sup>36</sup> Details from Work & Income (2009) available online from [www.workandincome.govt.nz](http://www.workandincome.govt.nz) [here](#).

<sup>37</sup> The government announced on 23 March 2010 that the yearly income numbers in Table 3 will increase later in 2010 by \$1,040 a year: details from [www.msd.govt.nz](http://www.msd.govt.nz) [here](#).

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