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4 June 2010

Deputy Commissioner, Policy
Policy Advice Division
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Allowing a zero percent tax rate for non-residents investing in a PIE

1. The Society welcomes the opportunity to make a submission in response to the April 2010 officials' issues paper *Allowing a zero percent tax rate for non-residents investing in a PIE.*

<u>Summary of general submissions</u>

Society supports the proposal

2. The Society supports the proposal set out in the paper, which it understands is part of a broader proposal to develop New Zealand as an exporter of high-value middle and back-office services for fund management companies.

3. In particular, it supports taxing non-resident investors in a PIE:

    3.1 on their[1] non-New Zealand source income, at zero percent;

    3.2 on their New Zealand source income, at the same rate as they would pay if they were investing directly into New Zealand, and had no New Zealand fixed establishment[2],

    regardless of whether the PIE has a New Zealand manager or not.

4. In the Society's submission, it is important that this is a regime which each PIE can elect into (and if it does not make the election, it would continue to apply the current 30% tax rate).

Need for local content

5. In order to ensure that the regime is not misused, is able to be properly monitored, and achieves the intended benefit, some kind of "local content" requirements should be imposed. There is considerable foreign precedent for this.

[1] Strictly speaking, their share of the PIE's non-NZ source income.

[2] With the additional benefit of a statutory exclusion from taxable income for gains and losses from sales of equity investments in Australian listed and New Zealand companies.

Other funds management situations also need to be considered

6. The Society notes that in relation to PIEs which are managed in New Zealand, this proposal is arguably concessional, when compared to either:

   6.1 direct investment by a non-resident using a New Zealand manager;

   6.2 investment by a non-resident into a partnership which is managed in New Zealand.

7. In the Society's view, it would be consistent with the Government's broader objective, of attracting funds management and related services to New Zealand, for the taxation of these types of investment to be reviewed at the same time or shortly after the introduction of the proposed regime. This would also ensure that any tax changes that are made do not create arbitrary and illogical distinctions, to the detriment of the tax system as a whole.

An effective package will require much more than tax changes

8. The Society notes that putting in place an effective package to attract the desired activities to New Zealand will require much more than tax changes. From a legal perspective, it will also require changes to securities laws and to corporate law. The Society would welcome the opportunity to contribute to these changes also.

Summary of specific submissions

The ability for New Zealand investors to re-characterise as non-resident investors

9. It clearly would not be desirable to limit the zero percent rate to individual non-resident investors. This would substantially and in most cases unjustifiably limit the scope of the proposal. Some further suggestions are set out below.

Manipulation of expenses between investor classes

10. Commercial considerations and existing tax law should prevent deductible expenses being applied disproportionately against investor classes holding New Zealand based assets as against classes which invest in foreign assets. The exception is where the two classes are stapled. Targeted rules should be able to deal with this issue.

International tax policy concerns

11. The proposal clearly will not be a harmful tax practice as defined by the OECD, provided disclosure of information obligations are complied with.

Option 1 or option 2

12. The Society can see no reason for having only one of option 1 and option 2. It should be possible to draft legislation, which allows PIEs to choose which option they wish to use (as they would choose whether to use the regime at all). This is consistent with the existing PIE regime, which allows 3 different choices as to how PIEs pay their tax.

13. In the Society's view, if one option is chosen, option 2 (look-through global investment option) is preferable as a matter of principle to option 1 (PIE with foreign source income option).

    13.1 Option 2 offers the possibility of attracting additional foreign capital to New Zealand, which option 1 does not.

13.2 The benefit of option 1 is that it avoids the need to attribute foreign and New Zealand source income and expenditure separately within an investor class (or PIE, in the case of a single class PIE) (all income derived by non-residents would be taxed at the zero percent rate, and all expenses would be non-deductible). The Society suggests that the difficulties of such apportionment be explored with industry participants. In terms of their expenses, since PIEs are investors, rather than trading business operators, apportionment may be easier than it would be for other businesses. Furthermore, if option 2 is adopted, PIEs that wish to avoid the need to apportion can do so by segregating New Zealand and foreign investments in different PIEs or classes.

13.3 Option 2 avoids the need for PIEs to monitor compliance with New Zealand investment limits.

General submissions - detail

Society support for the proposal

14 The Society supports the proposal. While the Society is not qualified to opine on likely take-up, it notes that the world wide pool of funds managed through collective investment vehicles such as PIEs has been estimated at US$20 trillion (see *The Granting of Treaty Benefits with Respect to the Income of Collective Investment Vehicles – Public Discussion Draft 9/12/09 – 31/1/10* OECD Centre for Tax Policy and Administration, at p.8).

15 The aim of the proposal is to produce spin-off benefits for the New Zealand economy, arising from the domestic provision of services to the PIEs in which the non-resident would invest. From a tax revenue perspective, the fees generated by these services would be taxable (to the providers) and non-deductible (to the Fund). Effectively, there is an export of services.

16 From the perspective of the legal profession, a significant number of the Society's members are involved in servicing the legal requirements of:

16.1 the domestic funds management industry; and

16.2 foreign fund managers who wish to offer their products in New Zealand.

These services include provision of appropriate legal documents (eg trust deeds and administration agreements), disclosure documents (investments statements, prospectuses and the like), taxation and other legal advice.

17 However, the New Zealand pool of savings is relatively small. The Society's members would welcome the opportunity to provide such services to a wider range of PIEs. Though their contact with lawyers overseas, and their own overseas experiences, many of them have familiarity with funds management outside New Zealand, and with cross-border funds management in general. The educational and other resources of the Society would be available to assist its members in meeting the challenge of servicing a growing offshore funds management industry.

18 Competition amongst jurisdictions to host activities relating to the administration and management of these funds is intense. This competition is not only between offshore financial centres such as the Caymans, Gibraltar, the Channel Islands and their kind. Ireland has a regime of this sort. Closest to home, Australia has been attempting to implement such a regime since 2004 (see *Australia as a Financial Centre – Building on Our Strengths* (the *Johnson Report*), A Report by the Australian Financial Centre Forum, November 2009, at p.56). In order for this initiative to succeed, it will require:

18.1 detailed research, to determine New Zealand's target market and what tax and other regulatory features will be required;

18.2 on-going regulatory support, both to:

(a) fine tune the regime as initially introduced. This will be needed to deal with issues which inevitably will be raised by potential investors and providers as the opportunity becomes more widely known and a real interest is taken in it;

(b) keep the regime up to date, to deal with changes in other jurisdictions.

19 The Society notes that the description of the proposal as a tax "exemption" (e.g. paragraphs 2.13 to 2.16 of the Issues Paper) is not particularly accurate or (therefore) helpful. It suggests that the proposal is a deliberate tax subsidy to a particular activity. That is not the view which the Society has of the proposal. It seems much more the logical outcome of treating a PIE as a look-through vehicle for tax purposes, which is a common model internationally[3].

20 The growing use of New Zealand trustee services by foreign settlors is an encouraging precedent for the proposal. Following the introduction of our current "settlor regime" for trust taxation in the late 1980s, there are now a number of organisations in New Zealand which provide trustee services largely or exclusively to foreign settlors.

Regime should be optional

21 It is important that the regime be an optional one (assuming that it will involve some additional compliance requirements over the current position). If it is not, PIEs which have a *de minimis* level of foreign ownership will have to either:

21.1 redeem the interests held by the foreign members This would be commercially undesirable in all cases and quite inappropriate in some cases, such as a superannuation scheme; or

21.2 incur the additional compliance costs imposed by the regime, for no benefit at all for most of their members.

Local content

22 It is likely that foreign fund promoters seeking to set up a PIE using the 0% rate would seek legal, tax and (possibly) securities law advice from New Zealand-based service firms. However, in order to ensure that the regime operates in a responsible manner, and for the desired benefits from the regime to materialise, it will be important for not only these but also other fund services to be provided domestically.

23 For example, the regime could require:

23.1 New Zealand resident directors;

23.2 a New Zealand audit of the PIE;

23.3 investor information to be held in New Zealand.

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[3] There is arguably an element of exemption, insofar as the 0% rate is applied to PIEs with sufficient NZ activity to give rise to a "permanent establishment" if the activities were carried out by a direct agent of the PIE investors. Even on that analysis, there is debate about whether a permanent establishment would appropriately give rise to any attribution of profit to New Zealand, over and above the income generated by New Zealand based service providers.

24 It would be important, in imposing these requirements, not to deviate from international norms. In that respect, the Society notes the example of Singapore's "Resident Fund Scheme" and "Enhanced-Tier Fund Scheme", which are also aimed at attracting non-Singapore investors to use Singapore fund vehicles. Both regimes apparently require both a local administrator and S$200,000 to be spend on local business each year. There are also other local content provisions in the Enhanced-Tier Fund Scheme.

Other funds management situations should also be considered

25 The Society is aware of at least two analogous situations, which in its view should be considered as part of the proposal. They are:

25.1 where a New Zealand manager seeks to manage funds provided by non-residents to make either New Zealand or foreign private equity or venture capital investments, through a New Zealand limited partnership;

25.2 where a New Zealand manager seeks to manage funds provided by non-residents directly.

There is a prima facie case that the same tax treatment should apply to the income attributable to the non-resident investors in these cases as is proposed to apply to a non-resident investor in a PIE.

Other law changes will also be required

26 The proposal will not work unless a range of potential impediments are addressed, of which tax is only one. Particular issues from a legal perspective are:

26.1 securities law. A securities law framework will be needed which meets the requirements of:

(a) foreign investors and their advisors;

(b) foreign securities regulators, who will have to approve any retail offerings in their jurisdictions;

26.2 corporate law. In jurisdictions where these kinds of proposals have been adopted, particular corporate law provisions have been developed which are aimed at meeting the needs of foreign investors. An example is the protected cell company which exists in a number of jurisdictions (see e.g. Gurnsey's *Protected Cell Companies Ordinance 1997*).

<u>Specific submissions - detail</u>

The ability for New Zealand investors to re-characterise as non-resident investors

27 The Society notes the concern that New Zealand investors might attempt to have themselves treated as non-residents in order to get the advantage of the zero percent rate.

28 It clearly would not be desirable to limit the zero percent rate to individual non-resident investors (cf paragraph 2.20 of the Issues Paper). This would substantially and in most cases unjustifiably limit the scope of the reform. That seems to be the conclusion of paragraph 2.21 of the Issues Paper also.

29 In our view, there are two aspects to this concern, both of which need to be addressed.

29.1 The first is ensuring that such recharacterisation is not possible under the law.

29.2 The second is auditability, i.e. having some ability to test compliance with the law.

Appropriate legal mechanics

30. In relation to the possibility of a New Zealand resident owning an interest in a PIE through a foreign company, in our view it would be difficult to exclude non-resident investors from the zero per cent tax rate. That would require the PIE to identify such investors. This might be difficult.

30.1 The foreign company might hold its interest in the PIE through one or more nominees. The nominees would therefore have to be asked to collect information about their principals, which might be difficult.

30.2 Some kind of updating of the information, to identify any change of status, would be required.

Also, this approach would involve collecting information from a great number of holders (some of whom might not be sure whether they were CFCs or not), in order to identify the very small number who might be affected.

31 The better approach, therefore, would be to allow the PIE to apply the zero per cent rate to all foreign investors, and place the onus on the relevant New Zealand party (the shareholder in the case of a FIF, the New Zealand settlor in the case of a New Zealand-settled trust with a non-resident trustee) to pay the tax.

32 If the interest is a portfolio interest subject to the FIF regime, the resident will be subject to tax on some kind of attribution basis (FDR, CV etc) in any event, and there is not likely to be any material or systemic New Zealand tax benefit from such a structure. On the other hand, such a structure would inevitably have a degree of additional cost, complexity and (likely) foreign tax risk involved.

33 Thought will need to be given as to whether non-FIF portfolio interests (eg in Australian listed companies) could potentially be used as conduits for investment by New Zealand residents into PIEs.

34 If the interest is subject to the CFC regime, the Society :

34.1 agrees with the suggestion to categorise PIE income as passive income for purposes of the CFC regime; and

34.2 suggests that an Australian company which earns PIE income (perhaps above some *de minimis*) should not be treated as a non-attributing Australian CFC. Derivation of PIE income is not something which is likely to happen inadvertently, or for which there would be any business imperative. Accordingly, the consequence of loss of non-attributing status should be one which would arise only from a voluntary and conscious action.

35 If the PIE investment is held by a non-resident trustee of a foreign trust with a New Zealand resident settlor, the usual tax consequences arising from derivation of income by the trustee should apply. Broadly, either:

35.1 tax will be paid by the trustee (section HC 24 and HC 25); or

35.2 tax will be paid by the settlor (section HC 29); or

35.3 distributions from the trust to New Zealand beneficiaries will be subject to a penal level of tax (section HC 34).

36 Payment of tax by either the trustee or the settlor will be required in all cases unless either:

36.1 no settlement has been made on the trust at any time after 17 December 1987; or

36.2 any settlement made after 17 December 1987 was made by a settlor who had never been New Zealand resident at any time up to and including the settlement date.

Auditability

37 Currently, there is no audit issue in this respect. A PIE will pay tax at 30% on the income of any investor unless it has that investor's IRD number. Under the proposal, no tax will be paid on the income of a person who represents to the PIE that they are non-resident. The issue that presents itself is what will be required of the PIE in order for it to treat a person as non-resident.

38 Fortunately, there is a parallel to this situation, in the area of withholding tax. For example, a New Zealand resident bank will pay 2% approved issuer levy with respect to interest paid to a person who provides the required details of non-resident status. All that appears to be required for this purpose is for the holder to provide a signed statement to the bank, stating their name and address, and the country of which they are tax resident. These requirements should also be adequate in this case.

Manipulation of expenses between investor classes

39 The possibility of over-allocation of expenses to New Zealand source income is raised in paragraph 2.22 of the Issues Paper. The paragraph states that this could happen in a PIE, which has more than one investor class.

40 In our view, commercial considerations, and the current law, prevent any such over-allocation.

41 Commercial considerations should generally prevent deductible expenses being applied disproportionately against investor classes holding New Zealand based assets as against classes which invest in foreign assets. Unless the units in each class are held pro rata by the same people, any such allocation will have a commercial effect greater than its tax effect, and would not be acceptable to investors in the class to which the expenses are overallocated.

42 For that reason, multi-class trusts will generally contain a clause requiring the equitable allocation of expenses. We **attach** an example as Appendix A to this submission.

43 The only time this commercial consideration will not apply is where units in the two classes are stapled, or otherwise held in the same proportions by the same investors. Even in this case, the tax law should not allow an over-allocation of expenses to New Zealand income.

43.1 A PIE is subject to the ordinary deductibility rules in most respects. Accordingly, expenditure is generally not deductible unless it meets the general deductibility test in section DA 1. This section only allows a deduction for expenditure to the extent that it is incurred in deriving assessable and/or excluded income (or in carrying on a business for

the purpose of deriving such income. It does not allow a deduction for expenditure to the extent it is incurred in deriving either:

(a) non-resident's foreign source income; or

(b) non-resident passive income (this latter exclusion is in section DA 2(5)).

43.2 The deductibility provisions therefore contain a requirement to make an allocation of expenditure, which is incurred to earn two types of income. The taxpayer bears the burden of establishing a sensible basis of apportionment, and the Commissioner is entitled to challenge the basis adopted if he believes it is not in accordance with the facts.

44 There will be a need for a change to the interest deductibility rule. Under current law, a PIE is entitled to an automatic deduction for interest expenditure under section DB 7. That it is because PIEs will in most cases be either companies or unit trusts, which are taxed as companies. The derivation of non-resident's foreign source income or non-resident passive income is not a barrier to the deduction of interest under section DB 7. So, some modification to this blanket deductibility rule will be required for PIEs, which earn income that is taxed at 0% under this proposal.

45 Even in this case, rules to prevent misallocation of expenditure between investor classes should only be necessary for multi-class PIEs which;

45.1 have interest expense (which many PIEs do not have); and

45.2 have one or more classes of units with identical ownership (which would be unusual), some of which ownership is non-resident.

46 The Society notes that the issue of allocation of expenses under option 2 of the proposal is a separate matter, which is also discussed below.

International tax policy concerns

47 The proposal should not be a harmful tax practice as defined by the OECD, provided disclosure of information obligations are complied with. The 1998 OECD Report *Harmful Tax Competition – An Emerging Global Issue* identifies at paragraphs 60 to 84 the features of harmful preferential tax regimes. Critically, the Report identifies that such regimes require both a low or zero effective tax rate combined with one or more of the following:

47.1 restricting access to the regime to foreign investors;

47.2 lack of transparency;

47.3 lack of effective exchange of information.

48 With respect to these factors:

48.1 While the proposal does involve a zero per cent tax rate, where that is provided on the basis that the income is not appropriately within the New Zealand tax base in any event, it may not be relevant.

48.2 The PIE regime, and the 0% rate, will be available to local investors.

48.3 There will be no lack of transparency, or lack of effective exchange of information.

Accordingly, it seems clear to us that the proposal would not be a harmful tax practice. Furthermore, the Society notes that similar regimes appear to be in place in other jurisdictions. For example, Australian managed investment trusts appear to give a similar outcome.

Option 1 or option 2

49 In the Society's view, the best outcome would be to allow PIEs to choose between option 1 and option 2. While this would require the development of more rules, the key to success of the regime will be for it to be user friendly. Assuming that there is a commercial demand for both options, that demand should be met.

50 There is precedent for this kind of approach in the existing PIE rules. In order to accommodate different business models and processes, those rules provide three options for calculation and payment of PIE tax (provisional, quarterly, and daily exitor). It would have been much simpler from a legislative perspective to provide only one. However, this would have denied the benefit of the regime to those funds which would not have been able to adapt to whichever of the three possible regimes was chosen.

51 Allowing both options will allow the regime to be used by:

51.1 fund providers with a minimal level of New Zealand investment and who wish to minimise tax compliance costs;

51.2 fund providers who wish to:

(a) undertake a greater level of New Zealand investment (which is obviously a good thing); and

(b) avoid the need to monitor compliance with any restrictions on New Zealand investment levels.

52 If one option only were selected, in our view option 2 would be preferable as a matter of principle. It provides a regime, which is more flexible as a business matter, albeit that it might require more detailed record keeping and systems. However, industry feedback on this point will obviously also be important.

Nature of New Zealand investment restrictions in option 1

53 Again, this will need to be determined in consultation with industry. Our observations are:

53.1 for New Zealand cash, call and short term deposits, an annual average should be used, perhaps with measurement dates and an anti-avoidance rule;

53.2 onshore derivatives used for hedging purposes should be permissible with no limit;

53.3 the level of New Zealand equities should be set by reference to an average annual asset value, which will tend to be less volatile than earnings.

Treatment of inter-fund investment

54 The Society notes that whichever option is chosen, the fund should be entitled, if it can obtain the necessary information, to treat any PIEs into which it invests as transparent. That is, a fund (Investing Fund) which is applying the 0% rate to foreign (and perhaps New Zealand *de minimis*)

income attributable to non-residents should be able to treat itself as holding and earning the appropriate percentage of the assets and income of any PIE into which it invests (Investee Fund), if the Investee Fund can provide it with the appropriate breakdown. This will ensure that the offshore income earned by the Investee Fund can be taxed at the 0% rate in the hands of the Investing Fund, to the extent it is attributable to foreign investors in the Investing Fund.

If you wish to discuss this submission further please contact the Taxation Committee Convener, Mr Casey Plunket, through the committee secretary, Julie Smith - phone (04) 463 2967 or email julie.smith@lawsociety.org.nz.

Yours sincerely

Jonathan Temm
President

Appendix A

Expenses

All expenses reasonably and properly incurred by the Trustee or Manager in connection with a Trust or in performing their obligations under this deed are payable or reimbursable out of the Assets of that Trust and (where there is more than one class of Unit) shall be allocated by the Manager on an equitable basis between Portfolios. This includes (without limitation) expenses connected with:

- this deed and the formation of a Trust, any supplemental deed and the filing of this deed;
- preparation, review, distribution and promotion of any prospectus or offering memorandum in respect of Units;
- the sale, purchase, insurance, custody and any other dealing with Assets;
- investigating and evaluating any proposed investment;
- the administration, management or promotion of a Trust or its Assets and Liabilities, property and project management fees and expenses;
- convening and holding meetings of Unit Holders, the implementation of any Resolutions and communications with Unit Holders;
- Tax (provided it is not on the personal account of the Trustee or Manager with no statutory basis for passing the impost of the Tax on to the Trust) and bank fees;
- the engagement of delegates, underwriters, agents, valuers, advisers and contractors of all kinds;
- preparation and audit of the taxation returns and accounts of the Trust;
- termination of the Trust and the retirement or removal of the Trustee or Manager and the appointment of a new trustee or manager;
- any court proceedings, arbitration or other dispute concerning the Trust or any Asset, including proceedings against the Trustee or the Manager by the other of them (except to the extent that the person incurring the expenses is found by a court to be in breach of trust, in default or to have been negligent); and
- any goods and services tax applicable to any fees or expenses of the Manager or Trustee.