



29 April 2011

Mr Craig Foss  
Chair, Finance and Expenditure Committee  
Room 9.10, Bowen House  
Parliament Buildings  
Wellington

Dear Mr Foss

**Taxation (Tax Administration and Remedial Matters) Bill - submission on SOP 220**

The New Zealand Law Society (Society) appreciates the Finance and Expenditure Committee's invitation to make a further submission on the Taxation (Tax Administration and Remedial Matters) Bill in relation to SOP 220. This further submission has been prepared with assistance from the Society's Taxation Committee.

**General**

1. The Society supports the aim of SOP 220, to introduce law allowing PIEs, on an optional basis, to apply, to income attributable to foreign investors, tax rates similar to those which would have applied had the foreign investors earned the income directly. The Society also supports the concept of such foreign investor PIEs (or FIPIEs) being split into:
  - 1.1 PIEs that can apply a 0% rate to all of their income because their New Zealand income is *de minimis* (we refer to these as 0% FIPIEs); and
  - 1.2 PIEs that apply a withholding tax-type rate to the New Zealand source income attributable to non-residents (we refer to these as Variable Rate FIPIEs).
2. However, the Taxation (Tax Administration and Remedial Matters) Bill as drafted is deficient in a number of respects. It is important that these deficiencies are addressed in order for the regime to be attractive to New Zealand and foreign-based financial product providers.

**Proposed section HM 55B is mis-labelled**

3. Proposed section HM 55B is headed "Modifications to entry rules for foreign investment PIEs". In fact, only one of the eight modifications in the proposed section is a modification to the entry rules, properly understood.
4. The entry rules for PIEs are not all of the requirements in sections HM 8 to HM 20. The drafting of section HM 7, and also section HM 71, makes it clear that the entry rules are only sections HM 8 to HM 10, HM 17, HM 18 and HM 20. The further requirements as to investment type, income type and investor type in sections HM 11 to HM 16, and the

fully crediting requirement in section HM 19, are requirements that often are not met by entities when they first choose to enter the PIE regime.

5. While this may seem a minor point, when the legislation creates a distinction, for it to then not continue to preserve that distinction will create uncertainty and confusion, often in ways which are very difficult to anticipate.
6. Accordingly, the following amendments are recommended:
  - 6.1 The word “entry” should be removed from the heading to proposed section HM 55B and from proposed subsection (1).
  - 6.2 Proposed subsection (2) should state as follows.

*“For an entity to be a foreign investment PIE, it must maintain the requirements of the rules in sections HM 8 to HM 20, modified by the following paragraphs:”*

### **Treatment of New Zealand source financial arrangement income**

#### ***Overview***

7. Non-interest income from financial arrangements is not appropriately dealt with in the SOP. There are two issues.
  - 7.1 A PIE cannot be a 0% FIPIE if it derives any amount of income from financial arrangements which is:
    - (a) New Zealand sourced; and
    - (b) not interest income.

In our view this is inappropriate, and a 0% PIE should be able to derive any amount of New Zealand sourced non-interest income. The proposed restriction will simply force PIEs which want to be 0% FIPIEs to enter into derivatives transactions with non-New Zealand counterparties. This is detrimental to the purpose of the proposal, which is to attract activity to New Zealand.

- 7.2 A Variable Rate FIPIE is taxed at 1.44% on all income from financial arrangements, including income which is not interest income. This is inappropriate because non-interest income from financial arrangements would generally be taxed at 0% if earned directly by a foreign investor.

#### ***Detailed submission on 0% FIPIE and financial arrangement income issue***

8. The 0% FIPIE option is concessional, in that it allows a PIE to pay no tax on income, which would have been subject to tax if earned directly by the foreign investor. This simplifies compliance considerably, at the cost of a small amount of revenue. This option is only available where the amount of otherwise taxable income is *de minimis*, and can be justified on commercial grounds, i.e.:

- 8.1 holding funds in New Zealand bank accounts for liquidity purposes (with respect to which New Zealand funds of no more than 5% of the PIEs total worth has been set as the limit);
- 8.2 holding interests in New Zealand companies as part of a balanced share portfolio.
9. However, the basis for this submission that a 0% FIPIE should be allowed to derive any amount of New Zealand source non-interest financial arrangement income is somewhat broader. Non-interest financial arrangement income derived by a non-resident who has no place of business in New Zealand is not subject to New Zealand tax at all, whether the income has a New Zealand source or not. This is for one of two reasons:
- 9.1 The non-resident is resident in a country with which New Zealand has a tax treaty. Although treaties generally allow the source country to impose a certain level of withholding tax on interest, the “interest” provisions do not apply to non-interest income from financial arrangements. Accordingly, the business profits or other income articles will usually apply, and will prohibit source country tax; or
- 9.2 It is not practically possible, nor internationally acceptable, to attempt to collect tax, from non-residents with no source country presence, on non-interest income from derivatives, hedging, and similar financial arrangements, even where the non-resident is not in a treaty country.
10. The rationale for the FIPIE changes are that non-resident investors in a PIE should be taxed in the same way as if they had invested directly in the assets held by the PIE (proposed section HM 6(1)(ab)). This rationale supports treating New Zealand sourced non-interest income from financial arrangements in the same way as foreign sourced income, and allowing a 0% FIPIE to derive any amount of it. This treatment is not concessional compared to direct investment by the foreign investor.
11. Accordingly, we submit that proposed section HM 55G(c) should be amended by having added to it a further subparagraph as follows.

*“(iii) income from financial arrangements to the extent that it is not interest income.”*

***Detailed submission on Variable Rate FIPIE and financial arrangement income issue***

12. Row 4 of proposed Table 1B in Schedule 6 states that a Variable Rate FIPIE must pay tax at 1.44% on New Zealand source income from financial arrangements. This is appropriate in relation to interest income, which would be subject to a tax-deductible levy of 2% if paid directly to the foreign investor.
13. For the reasons referred to in our submission on the Taxation (Tax Administration and Remedial Matters) Bill,<sup>1</sup> this rate of tax is not appropriate in relation to non-interest income, such as income from derivatives, or gain on a sale of bonds to another holder, or a foreign currency gain. This income is taxed at 0% if derived directly. It would also be possible for FIPIEs to prevent this type of income from having a New Zealand source by entering into derivative contracts with foreign, rather than New Zealand, counterparties.

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<sup>1</sup> New Zealand Law Society submission dated 21 February 2011.

That would be contrary to one of the policy objectives of the legislation, i.e. to stimulate activity in New Zealand by removing an unjustified and accidental tax barrier.

14. Another reason for not taxing non-interest financial arrangement income derived by a FIPIE is that it would create an inconsistency between the treatment of income and the treatment of losses. For example, suppose a Variable Rate FIPIE has a loss from a derivative contract on a particular day. That loss will not be deductible, by virtue of section DB 54B. It would be inequitable not to allow a deduction, while taxing the gain.
15. Accordingly, row 4 of proposed Table 1B should be amended so that it refers only to interest income, and row 6 of proposed Table 1B should also refer to non-interest financial arrangement income derived from New Zealand.

#### **De minimis FIPIEs should be permitted to invest in call accounts**

16. As proposed section HM 55G is currently worded, a FIPIE arguably cannot qualify for the 0% rate on all income if it derives any income at all from a call account. That is because it only permits interest income from financial arrangements with a term of 90 days or less. A call account has no term, and therefore arguably does not meet this requirement.
17. In our view it would be desirable to amend paragraph (a) so that it also refers to financial arrangements at call.

#### **Investment in land investment companies should be permitted**

18. The SOP provides that a FIPIE may not invest in:
  - 18.1 Land situated in New Zealand; or
  - 18.2 A land investment company, defined broadly as a company that derives more than 90% of its worth from land (wherever situated). (We note that this definition does not require a PIE to hold any particular percentage of a company in order for it to be a land investment company).
19. We understand that the reason for the first restriction is that it is not thought appropriate to tax land on a gross basis. Therefore expenses attributable to deriving income from land would need to be deductible against the land income derived by a FIPIE and attributable to foreign investors. For a FIPIE with both land and non-land assets, there would therefore need to be a set of rules dealing with the apportionment of expenses so that expenses would be:
  - 19.1 deductible to the extent incurred in earning income from land;
  - 19.2 non-deductible to the extent incurred in earning other income (all of which would be taxed on a gross basis).

Rules might also be needed to deal with net losses incurred in relation to land. Rather than draft such rules, the Government has proposed to prohibit FIPIEs from investing in land at all.

20. The Society's submission does not seek to challenge this policy, or the prohibition on a FIPIE investing directly in land. However, we do not think the same issue arises with respect to investment in a land investment company. Expenses that relate to the earning of income from the land will not and should not be deductible to the PIE at all. Those expenses are only deductible to the extent incurred by the land investment company, because only it derives the income from the land. Expenses which relate to the earning of dividends from the land investment company will not and should not be deductible to the PIE, because the dividend income is taxed on a gross basis, just as if it had been earned directly (see also proposed section HM 35C(3) and (4)).
21. In other words, the apportionment issue does not exist for a PIE which holds shares in a land investment company, because expenditure incurred by the PIE will continue to not be deductible.
22. Accordingly, proposed section HM 55(2)(e) should be omitted.

***Alternative submission***

23. If the submission above is not accepted, the definition of a land investment company for this purpose at least should be amended so that it applies only to a company that derives 90% or more of its value from land situated in New Zealand.

**Source rule modification**

24. Proposed section HM 55C modifies the source rules by providing that income attributed to a foreign investor by a FIPIE will not be treated as New Zealand source on the basis that the business of the PIE is carried on in New Zealand. This is necessary in order to ensure that foreign source income (e.g. dividends from foreign shares) can be treated as foreign source and therefore subject to the 0% tax rate for non-residents, even where the PIE is managed in New Zealand and its income might therefore have a New Zealand source under section YD 4(2).
25. This modification needs to go further, and also provide that income attributed to a foreign investor by a FIPIE will not be treated as New Zealand source on the basis that:
  - 25.1 Any contract giving rise to the income is made or wholly or partly performed in New Zealand. If this is not done then, for example, income derived by a PIE from the sale of a bond where:
    - (a) the bond is issued by a foreign company; and
    - (b) the sale contract is entered into in New Zealand,
 might have a New Zealand source under section YD 4(3). We do not believe that outcome was intended, nor that it would be appropriate.
  - 25.2 The income has a New Zealand source under the catch-all provision, section YD 4(18). If this is not done then significant uncertainty will remain as to whether income derived by a FIPIE could have a New Zealand source.

### **Investor class - section HM 35C(2)**

26. As drafted, proposed section HM 35C(2) appears to require a PIE to treat all its notified foreign investors as a single separate investor class for purposes of the calculation of the PIE's income tax liability and the investors' attributed PIE income. While this might be feasible, it does not seem to be appropriate for a multi-class PIE with notified foreign investors in more than one class. So far as we know, it is not intended that all such foreign investors be treated as members of a single synthetic class. Rather, it is intended that the notified foreign investors within each class be treated as a separate class. So, for example, if a PIE has two classes of investor interests, with notified foreign investors in both of them, then if it elects to be a FIPIE, it will for calculation purposes treat itself as having two additional classes of investor (not one).

### **Application of regime to Proxies (or PIPs)**

27. It is proposed that section HM 33 is amended so that a proxy must pay income tax on behalf of a notified foreign investor in a foreign investment PIE. This appears to make it compulsory for a PIP to apply the FIPIE rules. This should not be problematic for PIPs acting on behalf of notified foreign investors investing in FIPIEs which invest only offshore, and whose income attributed to notified foreign investors is therefore all taxed at 0%. However, suppose that the underlying PIE is a FIPIE that also holds New Zealand investments. Where a PIP holds an interest in the PIE on behalf of a notified foreign investor, the amendments to section HM 33 appear to make it compulsory for the proxy to apply the differential rates in Table 1B. We suppose that this would require a systems change for the relevant PIP.
28. If the legislation is enacted as proposed, proxies which do not wish to offer the differential rates could simply refuse to hold interests in such FIPIEs for notified foreign investors. Preferably, the legislation could be drafted so that it is voluntary for proxies to treat foreign investors in FIPIEs as notified foreign investors. This would be consistent with the generally optional nature of the reforms.

### **Procedural issues – safe harbours, transitions, etc**

#### ***Safe harbour for PIE***

29. As proposed, section HM 55D requires a PIE to apply the 28% rate to a person who notifies the PIE that they wish to be a notified foreign investor, if the person:

29.1 does not meet the non-residence requirements (which include not being a CFC or the non-resident trustee of a trust that is not a foreign trust); or

29.2 does not provide the PIE with the necessary information (see section HM 55D(5)).

This is appropriate as regards a failure to provide the necessary information. It is not appropriate as regards the residence requirement. The PIE should not be required to look behind the investor's representations that they qualify as a foreign investor. The situation should be the same as that which applies when a resident notifies an incorrect

PIR. That is, the PIE applies the rate they have been given, and the consequences fall on the investor.

30. There is no need for the opening words in proposed section HM 55D(8) “*Despite subsection (3)(a)*”. There is nothing in subsection (3)(a) which is over-ridden by subsection (8).

***Transitional issues***

31. Transitional issues seem to be dealt with largely in section HM 55E. Unfortunately that provision is poorly drafted.
32. Subsection (1) states that subsection (2) applies when a notified foreign investor in a FIPIE:
  - 32.1 becomes New Zealand resident; or
  - 32.2 cancels their notification.
33. Subsection (2) then deals only with tax years after the year in which the person notifies the PIE of their change in status. It says that in tax years after that notification, the person must include all PIE income attributed to them as a notified foreign investor in their return of income for the relevant year.
34. The difficulties with these subsections include the following:
  - 34.1 They do not prescribe what happens if a notified foreign investor becomes a CFC or a non-resident trustee of a trust that is a foreign trust. Presumably, this should have the same effect as becoming New Zealand resident, but that is not stated.
  - 34.2 The relationship between the “tax years after the tax year in which the person notifies the PIE of the change in their status” and “the relevant tax year” is not clear. The opening words of subsection (2) appear to restrict the section’s application to years after the notification. The later words appear to require it to apply before that notification.
  - 34.3 Surely if the PIE has been notified of the investor’s change in status, it will cease to attribute income to them as a notified foreign investor (see subsection (4)), so that in years after the notification is received, there will be no such income, and the PIE will apply the usual PIRs applicable to residents. Perhaps subsection (2) should apply only to the year in which the notification is received.
  - 34.4 They do not prescribe any consequences where the person becomes New Zealand resident but does not provide any notification.
35. In terms of the overall scheme, in our view the following would be appropriate:
  - 35.1 An investor who is a notified foreign investor has an obligation to inform the PIE if it ceases to qualify;

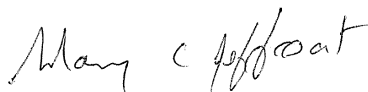
- 35.2 An investor who meets the requirements for being a notified foreign investor can inform the PIE that they wish to be so treated (and must provide the necessary information);
- 35.3 A PIE has an obligation to give effect to such a notification, as soon as possible thereafter, but in any event no later than the beginning of the year following notification; and
- 35.4 For any attribution period in which a PIE treats a person as a notified foreign investor when they are not one, the person is liable to pay PIE tax at their correct PIR, with a credit for tax paid by the PIE on their behalf. There is no additional obligation on the PIE. This is the same treatment as applies to a person who has tax paid by the PIE at a lower rate than their actual PIR.
36. Further, proposed section CX 56(2)(c) is confusing. If a person who was a notified foreign investor informs the PIE that they are no longer such an investor, and the PIE proceeds to apply a usual PIR to that person, why should the person's attributed PIE income not be excluded under section CX 56(3)?
37. The Society's Tax Committee would be happy to provide further assistance with this aspect of the legislation if that would be helpful.

### **Choosing to become a FIPIE**

38. Proposed section HM 71B provides for the election by an entity to become a FIPIE. There are several issues with the proposed section:
- 38.1 Subsection (1)(a) seems to be intended to require that the entity meet the usual multi-rate PIE entry requirements. However, the entry requirements have been mis-stated, by including sections HM 11 to HM 16.
- 38.2 Further, proposed subsection (1)(b) requires the entity to meet the requirements of the modifications set out in section HM 55B, all but one of which do not relate to the entry requirements at all (see above).
39. Section HM 71B should be modified by refining subsection (1)(a) and omitting subsection (1)(b).

If you wish to discuss this submission further please contact the convener of the Society's Taxation Committee, Mr Casey Plunket, through the committee secretary, Julie Smith - phone (04) 463 2967 or email [julie.smith@lawsociety.org.nz](mailto:julie.smith@lawsociety.org.nz).

Yours sincerely



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