

ASFONZ

(The Association of Superannuation Funds of New Zealand)

Part 1 of our submission on the discussion document concerning collective investment vehicles

Issues of principle

September 2005

Taxation of Investment Income – a discussion document

Comments on the broad principles that we believe should underpin the recently released “government discussion document” on the “treatment of collective investment vehicles and offshore portfolio investments in shares”.

Summary of this submission

ASFONZ agrees that the tax treatment of “collective investment vehicles” (“CIVs”) needs to change. What we have is both illogical and unfair. The paper recently issued by the Minister of Finance¹ requested comments on a number of issues of detail concerning the government’s recently announced policy.

ASFONZ has decided to take a two-stage approach to its submissions on the Discussion Document:

- in this paper, we want to address issues of principle;
- in a follow-up paper, we will address the issues that are raised by the proposals described in the Discussion Document.

ASFONZ expresses considerable concern at the principles on which the Discussion Document is founded. We strongly urge the government to return to first principles when it decides how CIVs and their members should be taxed.

ASFONZ thinks that a “first principles” approach has not been taken to date. ASFONZ suggests that the Discussion Document’s key recommendations are both illogical and unsound. They will inevitably produce unintended consequences. They will introduce an unnecessary layer of complexity that will at the same time raise costs, lower understanding and increase inequity. Because they are unsound, the complexity will inevitably increase as providers game the system and test the boundaries.

The rationale for the Discussion Document’s proposals is to fix distortions in the present tax system and make it more attractive for savers to make portfolio investments through CIVs. However, ASFONZ suggests that the proposals in the Discussion Document add new distortions (e.g. a “one-off” tax-driven gain for the holders of New Zealand instead of overseas shares) and also add significant administrative complexities that may increase the overall costs (including tax) of investing in CIVs. ASFONZ understands the reasons for aligning tax rates with individuals’ marginal tax rates. However, if the solution introduces additional costs that mean the net return for an investor with a 21% tax rate is the same as, or worse than, at present, the tax alignment has served no useful purpose.

ASFONZ strongly believes that New Zealand does not need the Discussion Document’s framework in order to develop a logical and fair basis for the tax treatment of both CIVs and their members/investors. In this paper, we suggest a broad framework that should be used instead. Our “gold standard” framework does not require the invention of artificial definitions of income but instead recognises the true economic nature of the transactions involved. We think that the Discussion Document’s recommendations fail that key objective.

¹ *Taxation of investment income – The treatment of collective investment vehicles and offshore portfolio investments in shares, A government discussion document, June 2005 (the “Discussion Document”)*

The framework we describe does not involve tax concessions for superannuation schemes or other CIVs.

We think that the national debate on a tax regime for CIVs needs to include an option that offers a “pure” attempt to flow income from the CIV to investor/members. That would mean members’ being taxed on the basis that they had earned the income directly. We think we offer a practical foundation that will see the “income” of investor/members calculated in ways that will be familiar to taxpayers. Because the Discussion Document effectively recommends three new definitions of “income”, ASFONZ suggests that the Discussion Document’s recommendations do not provide that foundation.

ASFONZ urges the government to restart the process of developing a robust and workable framework for the tax treatment of CIVs and their members.

It is not too late to start again.

1. We do have issues to address

In principle, ASFONZ agrees that the tax treatment of what are now referred to as “collective investment vehicles” needs attention. Here are the broad objectives that we believe any changes should try to achieve:

- (a) **Principle 1:** If an investor participates 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, superannuation schemes, unit trusts, group investment funds, life insurance funds etc should all be treated similarly for tax purposes from the perspective of the individual investor.
- (b) **Principle 2:** 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 individual investor calculates income tax.
- (c) **Principle 3:** Again within reason, the tax the investor ends up paying on the CIV’s return should be as similar as it can be to the normal income tax the investor would have paid had the investment been held directly. This principle 3 should see the investor choosing a CIV for reasons other than tax – for example, for convenience, cost, diversification, management skills etc.

These principles form the “gold standard” against which, we suggest, any proposals must be measured. The present tax regimes that govern the different types of CIV comprehensively violate all three principles. Things therefore need to change.

Before discussing what should happen, we make the general point that, as a matter of public policy, CIVs should be “celebrated” and encouraged (that does not need to mean “subsidised”). Their continued development should be seen as a positive contribution to a successful financial services industry. CIVs perform a number of positive roles in New Zealand’s economic life, both at a macro and a micro level. In debating what ASFONZ sees as needed reform, we must think about how to make things both easier and better for CIVs.

ASFONZ accepts that the answer to the tax treatment of CIVs may need to be a mix of principles and practicality. However, the first preference should always be based on principle. Where principle and practicality are balanced in respect of a particular issue, ASFONZ prefers the principled approach. Over time, keeping to principles is more likely to provide a robust, coherent framework than the “easy” option of accepting concessions to practicality.

Compromise can be the basis for a particular change but only if that has the combined effect of simplifying things and increasing the net returns to investors with no significant loss of tax revenue. We do not think the Discussion Document’s proposals achieve these objectives.

ASFONZ strongly believes that the Discussion Paper should be set to one side and that the debate on the appropriate tax treatment of CIVs should start again.

2. Measuring the Discussion Paper's recommendations

We start by discussing how the key recommendations in the Discussion Paper measure up against the three principles of the “gold standard” stated in part 1 of this paper.

ASFONZ believes that the recommendations fail when measured against any of the three principles.

We do not think change can be called “progress” if one set of distortions is replaced by another unless the new arrangements are unambiguously more efficient.

If our suggested “gold standard” is the aim, the first objective should surely be to avoid distortions and, only if that proves impracticable, to then discuss what must be acknowledged as a second best alternative. Given the “gold standard's” objectives, in our view, the first step in that process has not been taken.

Here is why ASFONZ thinks that the Discussion Document's proposals offend the three principles of our “gold standard”:

- (a) **Principle 1:** After the changes have been implemented, we will have five different kinds of CIV – existing CIVs that retain their present treatment (seemingly for a limited period), New Zealand share-based CIVs (or that bit of a wider CIV that deals in New Zealand shares), overseas share-based CIVs (or, again, that bit of a New Zealand CIV that owns overseas shares), overseas CIVs that are subject to the FIF regime and finally, all other CIVs.

At best, that group may be reduced to four once New Zealand CIVs are forced to adopt the “flow through” treatment of individual investors (the Discussion Document proposes that this will, initially, be optional²).

- (b) **Principle 2:** The tax treatment of international CIVs that own shares will be completely different to their New Zealand share-based counterparts. However, neither approach seems to follow the usually accepted definitions of “income”. And neither treatment has the ordinary principles of income tax applied to the investment income that investors derive. The minimum requirements for a New Zealand share-trading CIV to qualify for this concession may well limit the potential for abuse³ but that does not alter the fact that this is a tax concession for CIVs that are “traders”. We suggest that it therefore fails the objectives of Principle 2.

- (c) **Principle 3:** Even under the “flow through” provisions (assuming that those apply), the income that an investor receives will not be treated in the same way as it would have been had the investments been held directly. Specifically:

- (i) The tax rate that applies will not be the current year's rate but the previous year's top marginal rate (not even the rate that would have applied had the whole of the imputed income been earned in the previous year).

² Paragraph 3.47 (at page 23) says “However, it is expected that the voluntary nature of the rules would be reviewed in the future.” We assume that means the “voluntary nature” aspect of the rules would become “compulsory”. That raises an issue with respect to CIVs that do not meet (or later breach) the QCIV qualifications if the new rules become compulsory. Paragraphs 3.40 to 3.43 of the Discussion Document contemplate their falling back on the current regime. But, if the look through were compulsory, what might the “tax rules existing for non-QCIVs” amount to?

³ We refer here to the minimum numbers required and to the issue of “control”.

This seems to be a violation of a basic principle of tax law that requires the tax calculation to relate to the income earned in the year to which the calculation applies⁴.

- (ii) “Income” declared by the CIV will not mean the same to the investor by comparison with the position for the same assets held directly.
- (iii) The “income” will not affect income-tested benefits and other income-related calculations such as Working for Families, student loan payments and the payment of family assistance.

This “income” will therefore not be treated in the same way by the government itself as income that the investor, in an otherwise identical position, would have received had the investment been made directly.

ASFONZ thinks that, if the state delivers an income-tested benefit then it is wrong in principle to exempt from the measure some income from exactly equivalent assets⁵. In substance, this special treatment is effectively a subsidy to the managed fund industry and carries with it all the distortionary elements of any state subsidy to a particular part of any industry.

At the very least, we would have expected the Discussion Document to identify the cost of this concession so that we may understand the trade-offs.

The thrust of the previously discussed proposals on the treatment of CIVs was to even up the tax playing field between direct and indirect investments.

However, we note that the Stobo Report essentially ignored the effect of “Effective Marginal Tax Rates”⁶. The Stobo Report’s recommendations were based on seemingly practical, rather than principled grounds⁷.

⁴ Apart from anything else, it forces the Discussion Document to suggest different thresholds than apply to “normal” income (at paragraph 4.94), penalties for a taxpayer’s failure to “elect the correct rate” (at paragraph 4.97) and (at paragraph 4.98) to suggest a mechanism to deal with over-payments of tax. All these result from the unnecessary breach of the “gold standard” principles that we describe. Those are not the only problems that this artificial application of the tax rate mechanism requires.

⁵ We found the justification for this particularly odd. Paragraph 4.88 (page 40) says, in summary, that QCIV-derived “income” should be treated differently because “there is a risk that those benefits might be clawed back in cases where a family saves via a QCIV. That would be inconsistent with both the aim of the Working for Families scheme and the broader intention to encourage more saving by New Zealanders.” We translate this to mean that tax-induced distortions to saving decisions are all right as long as we agree that those particular savings are “good” ones. We will discourage other types of saving (such as in a bank account) because we do not approve of them. Perhaps this is because investors have access to those savings before an “approved” retirement age and the regime should discourage such access. But, on the other hand, there will be some QCIVs where there will be the concessionary treatment and access (such as unit trusts) so we really can’t tell what the over-arching objectives might be – perhaps the promotion of unit trusts at the expense of superannuation schemes?

⁶ “Effective Marginal Tax Rates” (EMTRs”) allow for both direct income tax and any abatements in state-provided benefits (such as Working For Families) or direct obligations such as student loan payments or family support.

⁷ The Stobo Report *Toward Consensus on the Taxation of Investment Income* (October 2004) concluded at page 31 “I have no empirical evidence that such beneficiaries [recipients or payers of income-affected amounts],

The Discussion Document's recommendations will instead create new distortions. In principle, ASFONZ opposes such special deals.

3. The real issue

ASFONZ thinks that the real issue we should be debating is the principle of what we do now, together with its currently inconsistent application and lack of clarity. We acknowledge that rationalisation is needed but we do not accept that this requires the Discussion Document's recommended changes of principle.

We suggest it must surely be better to try to fix the failings of the current system rather than cover them over with another layer that, because it is new and very different, will introduce its own uncertainties and inconsistencies.

ASFONZ thinks that the changes to the treatment of overseas CIVs and New Zealand share-based CIVs will present savers (and providers) with their own problems. Inevitably, given their artificial nature, there will be unintended consequences so we think that some effort should be spent on identifying those before the new rules are implemented. How are providers (who must be expected to game the new rules) likely to behave⁸? Will this necessarily be to the advantage of savers? Intuitively, the answer to that is more likely to be "no" rather than "yes" – that is the principle of the Law of Unintended Consequences.

Finally, what damage might the uncertainty and gaming do to long term saving behaviour? Again, perverse outcomes may do more harm than any "good" that the Discussion Paper intends.

4. A fundamental principle is changed

ASFONZ suggests that the recommendations of the Discussion Document change a fundamental principle of New Zealand tax law. This states that if a taxpayer buys something with the intention of re-selling it for gain, the gain is taxable income. If, on the other hand, a taxpayer buys something with the intention of holding that asset for the income it produces then any gain achieved on re-sale is capital and is not therefore taxed. That law applies to investments, to goods and to property.

We accept that this principle has developed largely by default and we also understand that there are exceptions to this principle, such as the accruals regime for the treatment of fixed interest investments. We also understand there is a debate on whether that principle should be so (economists generally find it difficult to justify the different

per se, are an important source of savings. I therefore recommend that the proposed changes to the taxation of investment income are not altered to suit this class of investors. If the Government is concerned about the issue it should be addressed explicitly through altering how such benefits are administered." Given the actual (and recommended) expansion of "such beneficiaries" through the Working For Families programme, ASFONZ suggests that this "practical" approach cannot now be justified. We also think it could not be justified in 2004.

⁸ What, for example, is a "New Zealand share"? The Discussion Document made no attempt to define this expression. Given the clear incentives for CIVs to trade in "New Zealand shares" (as opposed to their overseas counterparts) we must expect the category of "New Zealand shares" to expand as synthetic products are developed to qualify for the concessionary treatment.

treatment of capital/income returns from investing⁹) but there is no suggestion, as ASFONZ understands the position, for that basic principle to be changed.

The regime suggested by the Discussion Document changes that basic principle in two main ways:

- (a) CIVs that buy “New Zealand shares” with the intention of re-selling them for gain will not pay tax on the gains. This places a CIV at a clear, tax-driven advantage over a direct investor in those same shares who buys them for the same purpose.

We do not understand the rationale for this exemption. The Discussion Document talks about the boundary between individual investors, who tend not to be taxed on gains, and CIVs that do. We have more to say about this situation in the next paragraph 5. But when the discussion comes to the vital issue of conferring a concession on a Qualifying Collective Investment Vehicle (“QCIV”) the best justification seems to be that QCIVs “are effectively operating as an investment decision-maker for their investors” (paragraph 3.3). We need, apparently:

“... to remove a significant tax barrier to diversified portfolio investment faced by those investing via savings and investment vehicles.” (paragraph 3.6)

Given that private investors generally escape being classified as being in “business” and taxed on trading gains, so (according to the Discussion Document) should a QCIV.

The same logic seems not to apply to CIVs that own overseas shares on behalf of individual New Zealand member/investors, despite owning the same type of asset and being faced with the same “significant tax barrier”. That distinction seems to have a different justification that we describe next.

- (b) CIVs that own overseas shares will be taxed on gains (whether or not realised) even if the shares were bought with the intention of holding them for the long term. Again, that treatment differs from what might be the case for directly held shares¹⁰.

The apparent reason for the distinction between the treatment of the two types of CIV is based on the way that the companies themselves are treated for tax purposes. The argument seems to run like this:

- Overseas tax jurisdictions tend not to have imputation tax regimes so that companies pay tax on their incomes and, separately, shareholders pay tax on their dividends. This amounts to double-taxation of the companies’ income (that “belongs”, ultimately, to the shareholders themselves).
- Overseas’ companies respond to this by having lower dividend rates than might otherwise be justified. The retained income (after local corporate tax) should then be reflected in the companies’ share prices. The economic returns from New Zealand companies, by contrast, are relatively fully taxed both at the corporate level and then again, at the

⁹ See, for example, *Financial systems and economic growth: An evaluation framework for policy* Iris Claus, Veronica Jacobsen and Brock Jera, New Zealand Treasury Working Paper 04/07, September 2004.

¹⁰ Though the rules on that will be changing if the total shares owned exceed \$50,000.

shareholder level with full account of corporate tax being taken when the shareholder files a return.

- If New Zealand taxes just the dividend income of overseas companies, it is not capturing an appropriate share of the full economic return earned by a New Zealand shareholder in those companies.
- We will therefore discard the normal concept of “income” and impose tax on the change in the share’s New Zealand dollar market value.
- On that basis, we do not need to know whether gains are of an “income” or “capital” nature or whether the New Zealand owner is a “holder” or a “trader”.

We think that such a change cannot be justified. We think we understand the difficulties at the interface between a world that treats investment (and savings generally) in a different way to New Zealand’s approach but we think the proposed distinction between CIVs that own New Zealand and overseas shares is not the answer. New Zealand has a unique tax environment. We are the only country in the world that has a TTE environment for retirement savings¹¹. We suggest that we need, therefore, to pay closer attention to the true nature of returns than other jurisdictions might need to. We do not think the Discussion Document does this.

We suggest that the Discussion Document should have identified what is at stake in this debate. What might be the expected revenue consequences of different approaches to this issue? Without that information, we think it is not possible to have an informed discussion.

Much has been made by commentators (including the Discussion Document itself) of apparent distortions between shares directly held and those held through CIVs but the difference is really one of administration (by the IRD) rather than of principle. We will have more to say about this below – see paragraph 6.17 (on page 18).

The financial services industry has also drawn attention to the apparently anomalous treatment of directly owned housing over CIV-held shares. Again, we suggest that the difference is one of administration over substance. The law already says that trading in property produces taxable income and we have seen only recent signs of the IRD’s starting to enforce that principle with respect to housing. However, CIVs that trade shares should pay tax on the profits they produce – they are traders.

There has been official concern expressed at the favoured treatment of “exempt” overseas CIVs or CIVs that operate in jurisdictions that favour different vehicles over the treatment of equivalent vehicles in New Zealand. ASFONZ thinks this is purely an administrative issue. As we understand the “grey list” arrangements, New Zealand’s IRD is not obliged to accept an overseas ruling on “exempt” status for the purposes of calculating a New Zealand investor’s liability for tax (subject to any specific provisions to

¹¹ In fact, the “rest of the world’s (apart from Australia)” EET regime means that other countries will tend not to “care” about the way in which economic returns from companies are double-taxed. As the world’s investment assets become increasingly owned by retirement saving schemes, companies will presumably become less concerned about the double taxation issue when they set their dividends.

that effect in a particular tax treaty). If our understanding is not correct then we suggest that the obligation needs to change – that change seems simple enough¹².

Finally, much is made of the apparent concessions given to saving products with “binding rulings” because they track an index¹³. Again, this “concession” is no more than a re-statement of the basic principle that we have described. Such a share fund is not “trading” but has a “buy and hold” strategy – any transactions are designed to maintain the asset mix in accordance with the chosen index. Its treatment is therefore entirely consistent with the distinction between “traders” and “holders”¹⁴. In fact, if the binding rulings were less prescriptive than now and based on principles rather than detailed regulation, such share funds would probably do less “trading” than they do now. Again, this is a matter of administration rather than philosophy.

This leads us to a discussion on why CIVs pay any tax in their own right. In some cases they should; in others, they do this, effectively, on behalf of their members.

5. “Proxy” for saver?

When the tax laws on the treatment of superannuation schemes were changed in the 1980s, it was always stated that the schemes would be treated as a proxy for their members¹⁵. That principle was, however, lost when it came to its practical application.

The IRD contended at the time that investment managers were in the business of investing and so, by definition, all of a CIV’s investment gains should be taxed. The Discussion Document repeats this at paragraph 4.7 (page 25). We continue to believe that this is a mistaken application of the principles of taxation and mixes two different concepts.

Investment managers are certainly in the business of investing but this means only that the profits they make on their own account should be taxable. It should not follow that their status as “traders” infects the status of their clients, especially if some kind of “look through” regime applies to CIVs. That should require the status of the CIV (at the top level) and the investor/member (at the second level) to be investigated. There is no suggestion that the status of a share broker (as trader) automatically affects the status of the broker’s clients. ASFONZ thinks that the same principle should apply to CIVs¹⁶.

For a “first principles” review, we now need to resolve this central issue. ASFONZ thinks that the originally intended “proxy” approach is the correct one (based on the

¹² New Zealand should, in theory, be encouraging the use of these vehicles as, from the perspective of the country’s welfare as a whole, if a New Zealand investor receives the investment income gross under the regime we suggest, there will be more net tax paid in New Zealand.

¹³ Even the Discussion Document itself says (at page 28 in the box headed *Key question: what would occur in relation to passive funds?*) that “The rulings that currently give passive funds a more favourable tax treatment are a tax distortion and influence investment behaviour in a particular way.”

¹⁴ See also the discussion in paragraph 6.18 on page 19 that suggests binding rulings are the philosophically correct way to tax share investments by investors who are “holders” rather than “traders”.

¹⁵ The *Government Economic Statement* of 17th December 1987 said (at page 23) “Because of the possible difficulties in attributing earnings to individual scheme members and policyholders, the scheme or life office will be taxed as a proxy.” That means as a proxy for the individual members or policyholders rather than as a taxpayer in its own right.

¹⁶ A similar approach was taken by Claus, Jacobsen and Jera in the Treasury Working Paper already cited. See the Appendix to the Working Paper at pages 39-42 for a more detailed discussion on the rationale for the “proxy approach”.

three “gold standard” principles described in part 1 above). However, we recognise that it is possible, before looking down to the investor/member level, for the CIV itself to be a “trader” in accordance with the ordinary rules that we have described.

We therefore suggest that the IRD now accepts the principle that whether a CIV is a “trader” or a “holder” should be assessed in the same way as for a direct investor. If the CIV is a “trader”, that settles the issue for the investor/member (with respect to investment gains) who will receive the net returns with no possibility of re-calculation. If the CIV is not a “trader”, the investigation should then move down to the investor/member level where a separate decision needs to be made.

6. The general principles of sustainable reform

ASFONZ thinks that, before the detailed recommendations of the Discussion Document are considered, we should return to the basic principles of our existing tax laws and examine ways in which we might reinforce those in order to achieve the rationalisation that we acknowledge is needed.

Without listing all the issues, the general principles of reform should, in our view, be as follows:

- 6.1. **Single treatment:** All CIVs should be subject to a single tax treatment. The Discussion Document’s proposals fail this objective. In fact, they further complicate the current environment by creating two new categories of CIV.
- 6.2. **“Down payment”:** 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 we think it is impracticable for the CIV itself to act as the calculator of that final liability. This has to be done at a taxpayer level as this is the only place where all the information about the taxpayer is available. With the recent integration of modern technology that we now see in the tax calculation process, this seems not to be the major challenge that it might once have been.

Requiring the CIV to calculate the supposedly “final” liability as proposed in the Discussion Document not only illustrates a breach of what we have described as the “first principles” but also shows a lack of appreciation of the costs of change. We also think it illustrates a failure to contemplate alternatives. The proposal requires concessions as to principles that thereby change the fundamental basis of New Zealand’s progressive tax regime. For example, it creates a new class of “income” in the investor’s hands. We see no need for that.

- 6.3. **Charities etc:** If the investor doesn't pay tax (say, because it is a charity or otherwise exempt¹⁷) or is an individual with tax losses, the tax paid on its/his behalf by the CIV should be recoverable. That will eliminate the present need to have a specific class of CIV catering for the exempt taxpayer. It will therefore reduce costs and increase investment options for this group of

¹⁷ Such as a community trust.

taxpayers. For taxpayers with losses, our proposal will ensure that the correct amount of tax is calculated in any year, not an artificially high construct that is really driven by administrative convenience rather than by principles.

6.4 Overseas CIVs: For overseas CIVs, the general rationale should be that, whatever the local tax status of the CIV (in whichever country it operates), if the New Zealand investor would have paid tax on the underpinning transaction had that transaction been carried out directly by the investor then tax will be payable by the individual participant in the CIV. This has a number of potential implications:

- a. An “exempt” status in, for example, the UK would be of no direct interest to the calculation of income tax in New Zealand¹⁸. What would matter was whether the product itself was a trader, according to the New Zealand test. That this is currently seen to be a problem for New Zealand tax purposes is, we suggest, an administrative rather than a substantive issue. The IRD has, under the “grey list” rules, treated the exempt status as the final word on tax liability. In our view, the IRD need not have taken that approach but could easily have looked through the appearances of the transaction to see the substance.
- b. If the overseas CIV is both a "trader" and locally "exempt", a New Zealand investor should not be able to get the advantage of a tax-free roll-up. In that kind of case, the New Zealand investor should take the gains and losses on an accruals basis, year by year, regardless of the CIV's distribution strategy. If that requires the investor to realise part of the CIV investment to meet the tax, so be it. This is similar to the basis on which the current FIF regime operates for non-“grey list” countries.
- c. Similarly, if the overseas CIV is not a trader (and neither is the New Zealand investor), the New Zealand tax should look through to the dividend/other income component of the CIV's return and could charge tax on that, whether or not the dividends are distributed.
- d. However, if the overseas CIV does not distribute investment income to the New Zealand investor then, by definition, the New Zealand investor could be deemed to have bought that investment with the intention of realising a gain on redemption. That would make all gains eventually taxable under the normal “trader” provisions we have already described. As between the options described in this and the previous paragraph c, we prefer the “look through” approach described in paragraph c rather than the redemption approach (which would yield tax gains from the deferral).
- e. The same principle should apply to transactions by an individual investor in the securities issued by a CIV or in CIV securities generally. So, if the New Zealand CIV has a binding ruling, for example, that means it pays no tax on capital gains (or if an overseas CIV has a “non-trader” status), a unit holder (including a financial service provider that provides investment services) should be liable

¹⁸ See, however, note 12 above (page 8) – New Zealand Inc. will collect more tax under our suggested approach if investment were in an “exempt” overseas CIV.

for tax on gains from dealing with the CIV's securities if, by his behaviour, he becomes a trader in that CIV's securities, or in CIV securities generally - more on trading and binding rulings in a moment.

Some investors may suggest that this sounds too complex and that it would be too difficult to gather and supply the required details to the New Zealand IRD. ASFONZ says that, if investors have not gathered such basic information for their own purposes, they really do not know what they are buying. We therefore suggest that our proposals will not impose an information burden on either investors or the IRD.

- 6.5. Tax paid overseas:** The status of the overseas CIV may, however, matter if that CIV paid a local tax on its operations. We are unsure whether this is a major issue given that New Zealand is the only country in the world that runs TTE as the tax treatment for retirement savings. However, in principle, if some tax has already been paid "on behalf" of the New Zealand investor by the foreign CIV then there is a case that, under the "knock for knock" principles of the "grey list" regime, the tax paid should be an offset against a New Zealand tax liability. Given the ability of promoters to establish vehicles in tax-exempt zones or in a zone where the vehicle has a tax-free status, this probably isn't a major worry. On the other hand, if the overseas fund paid tax at, say, 33% then the New Zealand tax authorities may receive no tax in respect of the New Zealand investor's derived income.

If the underpinning investments are in a non-"grey list" country then any tax paid in that country would not be taken into account in the calculation of New Zealand tax. Our suggestions will not affect that principle.

- 6.6. Superannuation schemes:** The Discussion Document is built on the assumption that it is possible to identify all the investors in respect of whom the CIV's income has been earned. In superannuation parlance, the CIV is a fully allocated, defined contribution arrangement. In the superannuation world (and perhaps elsewhere), life is more complicated than the Discussion Document's model suggests. We suggest that the Discussion Documents' regime does not sit easily with the way in which superannuation schemes operate in practice.

There are three particular cases that we raise in this context:

- a. Defined benefit schemes** – these are completely unallocated. At no time is it possible to identify the individual member taxpayers in respect of whom investment income has been earned. Because the Discussion Document's foundation was not, in our view, a "first principles" approach¹⁹, it did not ask the question "Who, in the case of a defined benefit scheme, is the 'investor'?" In fact, the answer to that question is not the member but is first, the trustee as immediate owner of the

¹⁹ In fact, the Discussion Document's description of a defined benefit scheme (at paragraph 4.59) is technically defective. The concept of "forfeiture" of contributions does not exist and the idea that contributions are sometimes repaid "but at a significant discount (calculated actuarially)" is wrong.

investment assets and next, the employer as underwriter of the defined benefit scheme's liabilities²⁰. Apart from security of benefit issues, the member has no direct concern as to (or "ownership" of) the scheme's investment income. Tax should not, therefore, be an issue for members in respect of the defined benefit scheme's investment income²¹.

- b. **"Reserve funds"** – even "allocated" superannuation schemes have unallocated amounts in their accounts. These are usually called "Reserve Funds" and are often the result of "fall backs" (see the next point) but not necessarily. That particular part of a scheme's assets/liabilities is simply money that has not been allocated to members.
- c. **"Fall-backs"** – when a member leaves a workplace superannuation scheme, some of the benefits that had previously been held in the member's name are not paid to the member because they were not fully "vested". That "fall-back" is usually credited to the scheme's Reserve Account. The "unvested" part of the member's account balances is not, in fact, the member's money at all. The member's entitlements to the "unvested" part of the account balances are contingent on, usually, completing a period of service or on leaving service other than through resignation (for example, by death or redundancy). They may, in the meantime, be held in an account to the member's credit but, until the contingency has been satisfied, the money is not the member's.

The Discussion Document proposes potentially complex "work-arounds" to deal with the real superannuation world on the basis that, without them:

"... such funds would be denied access to the proposed tax treatment of capital gains. This would motivate a significant shift in investment away from such funds, which would generate a tax-generated distortion of investment behaviour." (paragraph 4.63 at page 36)

ASFONZ finds this a difficult justification to follow on a "principles-based" approach to reform. In summary, this argument says that we are proposing to advantage CIVs that trade in New Zealand shares (we have already suggested that this is an unwarranted tax distortion) but we now have a problem. In the real world, we don't know who owns all the CIV's money and we don't want some CIVs to miss out on this tax break. More distortions are required.

²⁰ The same even applies to a defined benefit scheme that has what looks like a defined contribution component. For example, if the benefit is described as a multiple of "contributions + interest" – the fact that a member has an account to which interest is added does not justify the "flow through" approach to taxation of members' benefits as to the interest added each year. If the scheme is unallocated, we suggest that our principles-based approach to "flow through" should not affect the tax position of members.

²¹ We understand it has been suggested that pensioners should receive an advantage from the generally lower tax rates that they pay in retirement. This is on the assumption that the investment income earned by the scheme in respect of their pension somehow "belongs" to them. It does not. It belongs to the scheme. The only impact of any change to the tax rates on the scheme's investment income will be felt by the scheme's sponsor as it will change the balance of the cost of providing the scheme's benefits. It has nothing directly to do with beneficiaries.

The Discussion Document acknowledged that its suggested compromises might lead to changes in the behaviour of employers in the design of superannuation schemes. ASFONZ suggests that if the proposed changes were properly founded, employers would provide scheme designs that suited their human resource objectives rather than being driven by tax. That should also, surely, be the objective of changes to the tax treatment of CIVs.

In a superannuation scheme, investment income on money that is directly “vested” in the member’s name can be reasonably readily attributed to the member under the “flow through” procedure. Money that is not so vested belongs in principle (and in law) to the trustee and should be taxed in the trustee’s hands. To suggest, as the Discussion Document states, that this might lead to the development of defined benefit (or, more accurately, unallocated) schemes for 39% taxpayers, overlooks the other more important reasons that have led to the decline of defined benefit schemes (complexity, cost, investment and underwriting risks, mobile workforce, under-appreciated by members etc.) Since the tax reforms of 1987-1990, tax has not been a consideration so we think that the Discussion Document’s concern in this area is misplaced.

- 6.7. **What is “income”?** In our view, the issue of what constitutes “income” can be resolved by reverting to the “gold standard” that we described in part 1 rather than by inventing a new definition and laying that down on top of what we acknowledge is an unsatisfactory situation. Installing yet another way of taxing CIVs and inventing two new definitions of “income” seems to us to be a second preference rather than a first.
- 6.8. **A principles-based approach to “income”:** Defining “income” is an area in which a prescriptive approach of any kind (even the proposed foreign CIV regime) is likely to create problems. ASFONZ thinks it is unsatisfactory to leave this matter ultimately to the courts (the approach to date). So, ASFONZ recommends that New Zealand develops a regime that states the principle and then specifies a list of considerations that the Commissioner must take into account when determining whether a CIV (or an individual) is in the business of buying and selling a particular type of security, or any asset for that matter.

The Commissioner should be given a list of the criteria that the Commissioner is obliged to take into account when determining whether a taxpayer is a “trader”. These criteria might include, for example the period for which the assets were held; whether “intention” can be inferred from conditions that applied at purchase; whether the owner has a history; whether the trading pattern was part of a pre-published “passive” strategy, the annual rate of portfolio turnover etc.

Having stated the general rule and then gone on to enshrine some very general principles in the legislation, we would expect that the detailed and practical application of those rules would be left to practice notes, issued by the IRD. Those practice notes could even be as detailed as specifying which particular products qualify as “traders” and which do not. Or it could fill in

the gaps and, essentially leave matters to a product's auditors (or the New Zealand promoters) to specify what, in their view, the position is. Even if the product got it wrong, because of the imputed nature of the tax liability that we prefer (see part 1 above), any gaps could still be fixed at an individual investor level. The consumer might not like that and would take the issue up with the promoter. What we suggest therefore would be almost a self-regulating regime. There could even be an assumption that any CIV is a “trader” unless the IRD has ruled otherwise. For most overseas CIVs, that is more likely to be right than wrong.

- 6.9. Binding rulings?** This approach will probably reduce the need for binding rulings. Binding rulings should obviously still be allowed - the IRD should be able to give a statement of the tax treatment and expect to be bound by that statement. A CIV provider should be able to say to potential investors what the IRD says its tax position will be. That kind of information will encourage certainty and will help providers to develop new ways of delivering needed services to savers.
- 6.10. Compliance issues:** Compliance with practice notes would be a continuous requirement and would, presumably, let the IRD be a bit more flexible about its initial rulings because there would be less at stake in that initial process. So the considerable complexity and cost currently involved in getting a binding ruling could be replaced with a much less formal process that probably would not need to involve lawyers. Loosening up this procedure will increase innovation, will lower costs significantly and can make individual investors more aware of what they were buying. These are all good things and should be part of the new regime’s objectives. It will also eliminate artificial distinctions created by product providers. As we stated in part 1 on the three basic principles of the “gold standard”, it should not matter what a product is called or who issues it - it is the substance of the underlying transactions that matters. Our suggested regime will allow the IRD to keep a continuous eye on that substance and change its mind if it thinks that the substance has turned out to be different from the appearance²².
- 6.11. Circumstances, not tax:** In the end, we should be encouraging individuals to use either CIVs or direct investments for the best reason of all - that the particular approach suits their circumstances, not that tax drives the decision. ASFONZ thinks that the Discussion Document’s proposals fail that key objective. CIVs will be established in particular ways specifically for tax reasons. In our view, that does not represent progress.
- 6.12. New Zealand law applied internationally:** Our suggestion will also allow the New Zealand distinction between capital and income to be preserved across different jurisdictions. For example, New Zealand's treatment under the accruals regime of fixed interest investments can be applied to CIVs based in other tax jurisdictions. If a product mixed investments that may have different treatments under New Zealand law, the IRD could take a

²² For example, providers can be told through the practice notes that the IRD will “look through” any corporate or intervening CIV structures that are designed to insulate investors from tax liabilities in New Zealand. As new types of structure appear, the practice notes can quickly identify the substance, rather than the form of a particular arrangement.

“dominant purpose” approach (consistent with its tax treatment of charitable trusts and case law) if it wished or simply say that mixing wholly taxable securities with non-taxable or partly taxed securities “infects” the whole product. There is sufficient product differentiation available internationally for New Zealand providers to sidestep this issue at little cost and without limiting flexibility.

- 6.13. Building on the known:** Our approach will build on the known rather than creating new potential uncertainties with potential unintended consequences. Existing case law will still be relevant and that is a good thing. The proposed regime can also easily be applied to both overseas and New Zealand products alike. It will also help to sort out the tax treatment of direct holdings (not just CIVs) both in New Zealand and overseas. Fixing this issue domestically (to identify a clear distinction between “traders” and “holders” of all assets, not just investments) will also be a good thing.
- 6.14. The money to pay the tax:** One practical issue with our suggestion is the source of the money the investor/member needs to pay any additional tax that may be owing as a result of the “look through” treatment of income²³. Our suggestion will see the final liability resting at the investor level. The tax there may be higher than the amount paid by the CIV “on account” and which could, in the case of an overseas CIV, be zero. It could also arise for a New Zealand CIV because the addition of the “look through” treatment of income may move the member into a higher tax bracket.

There are at least three possible answers to this:

- a) The New Zealand CIV could apply tax at the top marginal rate for all members (currently 39%) so that, if there is a difference, there can only be a refund (rather than extra tax to pay) when the member’s final liability for the year is worked out.
- b) The New Zealand CIV could be authorised (regardless of the CIV’s legal obligations) to pay to the IRD any additional amounts of tax that arise from a proper, final calculation of the member’s liability. That could be handled in bulk once a year by direct credit after the IRD has done the final calculations for all members.
- c) As long as there has been no attempt by the member or the New Zealand CIV to deliberately under-estimate the potential liability, the IRD could simply carry over the liability to the following year. For a New Zealand CIV, it is unlikely to be a large amount in any case so, in that circumstance, we suggest that the “use of money” interest normally charged by the IRD should not apply.

Investors will need to make their own arrangements locally where they invest in overseas CIVs operating in “exempt” environments²⁴. There will always be some extra tax to be paid (unless the New Zealand investor is itself exempt or has accumulated losses). For an overseas-based CIV, we suggest

²³ This is a particular issue with respect to KiwiSaver schemes where the benefits will be locked in to a “retirement” age. It is also an issue with the Discussion Document’s proposals for overseas share-based CIVs.

²⁴ That is also the case with the Discussion Document’s proposals for overseas CIVs.

that the “carried forward” concession (paragraph c) above) should not be available.

- 6.15. Imputation:** Our suggested “proxy” regime will handle the imputation regime that applies to New Zealand shares. For a CIV that owns just New Zealand shares, the income that is passed through to the investor will carry with it the “down payment” component of income tax paid by the CIV and also the imputation component that can be applied against the investor’s other income tax liabilities.

In the case of a “mixed” CIV (which owns both New Zealand shares and other income producing assets) the imputation credit can be applied by the CIV against its own income tax liabilities.

- 6.16. Contributions to workplace schemes:** In principle, the contributions by an employer to a workplace superannuation scheme should count as part of a member’s pay and be taxable, along with the investment income earned and allocated under the “flow through” approach that we suggest. However, there are two types of cases that can probably be distinguished with respect to the contributions themselves:

- (a) **Salary sacrifice/total remuneration environments:** Where the employee can choose to change the mix of direct and indirect pay, the employee should not be able to gain the advantage that can accrue because of the impact of effective marginal tax rates (“EMTRs”) - see paragraph 2(c) above for more on EMTRs. In this situation, the employer’s contributions should be added to the investment income and the whole amount dealt with under the “flow through” approach. This will avoid the acknowledged, accidental tax-planning opportunities that are inherent in the current basis for taxing employer’s contributions.
- (b) **“Pay + benefits”:** However, in a pure “pay + benefits” environment, where the employee has the choice whether to join and collect the employer’s subsidy or not join and miss out, the position is arguably different. The employer’s contributions probably should not be counted as “income” in the year of payment because, almost certainly, the scheme cannot deliver the money to meet the extra tax in the member’s hands. In addition, the member may leave the scheme before the contributions become fully vested. However, in the year in which the member receives the benefit, the contribution component of the benefit should count as “income” in the year of receipt unless the benefit can't be taken in cash²⁵. Again, if the employee can choose not to receive the benefit but to defer it to, say, retirement, it should count in the same way as in the “salary sacrifice” case described in paragraph (a) above.

The approach that we suggest for employers’ contributions would allow the present regimes that collect “specified superannuation contribution

²⁵ Given that tax will be collected on investment income attributable to vested benefits under the “look through” or proxy approach, whether tax is collected on the contributions as they are paid (through “specified superannuation contribution withholding tax” in a TTE environment) or at the end when the benefit is paid (ETI) should, if anything, result in a higher amount of tax being paid on the contributions themselves. However, that will be partly or fully offset, for the member, by the advantage of timing. Investment income will be earned on the gross, rather than the net employer contributions.

withholding tax” (SSCWT) and “fund withdrawal tax” (FWT) to be abolished. SSCWT is a tax that employers pay as a proxy for the employee-members and approximately represents the value of the benefit conferred on the member. FWT was introduced in 2000 to limit tax avoidance opportunities that were created when the top marginal rate was lifted from 33% to 39%. Both SSCWT and FWT are complex and, because of their prescriptive nature, create unnecessary tax planning opportunities. The IRD is currently discussing ways of limiting tax avoidance through the application of SSCWT and FWT. Our proposals would avoid the need for further work on that review. However, transitional arrangements will be needed in respect of existing benefits where tax has already been collected on incoming employer contributions.

- 6.17. Unspoken sub-text:** ASFONZ thinks that there is an unspoken sub-text in the Discussion Document that has led, inevitably, to its recommended QCIV framework and the suggested treatment of CIVs that own overseas shares. We have already suggested that a number of aspects of the current regime (which needs fixing) are effectively attributable to administrative rather than substantive issues. It seems to us that the Discussion Document’s proposals are founded on burden-shifting when it comes to the administration of tax compliance at the individual investor level. Whenever there might be a choice as to where that burden is carried, the answer seems to be at the CIV level, possibly because there are fewer taxpayers to administer at that level²⁶.

The Discussion Document suggests (at paragraph 4.85 on page 40) that we need to get the QCIV regime in place to avoid large numbers of KiwiSaver members having to file tax returns when currently they do not have to. We also apparently need to worry about income-tested state-provided arrangements like family assistance, child support and student loan payments²⁷.

ASFONZ thinks these concerns are both alarmist and unnecessary. The present system seems to cope well with the millions of bank accounts that operate on a basis that is similar to the regime that ASFONZ suggests should apply to CIVs. We would like to understand why the bank account-based principles cannot also be adopted for CIVs.

We think that more attention needs to be focused on resolving the tax issue at the investor, rather than at the CIV level. As the Discussion Document itself says in relation to finding a better mechanism for recognising “excess tax credits, tax losses and expenses”:

“This would preclude the need for investors having to file a return automatically each year to claim any excess amounts. It is likely that technology solutions are available to achieve this, which is the approach favoured by the government.”²⁸

ASFONZ thinks that the same approach should be taken to the much more basic issue of calculating “income” derived by a taxpayer through a CIV.

²⁶ In our view, this is also the main reason why the earlier attempt to fix this issue (TOLIS) failed.

²⁷ We have already suggested at paragraph 2(c) on page 4 that excluding CIV-derived income from counting as income for these purposes is unjustified.

²⁸ From paragraph 4.78 on page 39.

In principle, we think it is the IRD's job to calculate and collect tax from CIV members. That should not be the responsibility of the CIV itself. Not only does this require "income" to be defined in unexpected ways but also the CIV does not have all the information it would need to do the job accurately and fairly. It also creates unnecessary tax planning opportunities.

- 6.18. Avoiding double tax on shares:** One final issue – ASFONZ believes that the tax treatment of returns on shares is actually correct as currently applied through binding rulings for "passive" investments in the case of CIVs and accepted, for most individual investors, as the treatment of directly held shares that are bought to "hold".

Leaving aside the position of "traders", if an individual buys and holds but ultimately sells, we think it is philosophically correct that there be no tax on the gains. That's because a share has a value today that is derived from the net present value of its expected future (after tax) dividends. The current market value of a share, in other words, already allows for income tax on those dividends. To tax the gain is, effectively, to tax the expected dividend stream twice, at least as to the part represented by the increase in value.

A change in market values is therefore really only a change in the market's view of the net discount rate of expected future dividends, allowing for tax, for a particular share.

So, the "trading" issue aside, a binding ruling for a "passive" CIV is not a tax concession; it reflects the proper economic treatment of the way in which any changes in a market's view of an expected future stream of net dividends should be treated (losses would not be deductible for the same reason). The treatment of direct holdings to capital account is similarly justified.

"Traders" are different - because of the reason for which they bought a share or a unit in a CIV (to resell for gain), any gain they make is not related to the expected net dividend flow even though the market may "think" that. That gain should, in accordance with the principles we have described, be taxed.

7. Conclusion

ASFONZ is seriously concerned at the direction proposed by the Discussion Document. We will, by the 30 September deadline, address separately the issues raised by the proposals set out in the Discussion Document but, as to first principles, ASFONZ thinks that the Discussion Document should be set aside for now so that we can debate openly what the tax system should be trying to achieve and how best it might do that.

For example, does everyone agree that our three principles (part 1 above) that create what we suggest is the "gold standard" should be used as the benchmark against which any of the changes proposed are measured?

We suggest that the required principles-based discussion on solutions did not happen in 2004 as part of the process that produced the Stobo Report; nor did it happen with the Discussion Document. Representatives of ASFONZ were spoken to in each case but we

felt that our involvement was restricted to testing key decisions, rather than debating their substance.

ASFONZ is therefore uncomfortable that its name has been used in the Discussion Document (paragraphs 1.14 and 2.26) to suggest that ASFONZ participated in the process that helped to develop the proposals. However, ASFONZ is prepared to do just that if we now restart the review process on a principles-based approach.

We do not support the changes that were recommended in the Stobo Report; nor the principles that underpin the proposals in this latest Discussion Document.

Tax policy aside, ASFONZ strongly supports the development of a national culture that encourages workplace saving as something that employers should be doing, absent any tax “signals”. This is not the appropriate place to argue the case for workplace superannuation provision but, putting to one side the proposed KiwiSaver regime, we think that there are several public policy initiatives aimed at the workplace that we would prefer over deliberate (or accidental) tilts to the tax playing field.

Likewise, we think that if individuals were choosing to save for retirement, they should first look to their employer’s scheme, especially if that were subsidised. Again, there are public policy initiatives that could help employees to see why that should be so.

However, these should, fundamentally, be issues for employers and employees to resolve privately (including collectively) between themselves. ASFONZ suggests that the government's role is to ensure that the regulatory environment makes it as easy as possible for employers to start and run schemes (and set the terms on which they do that) and then for individuals to join.

So, when it comes to setting a tax policy framework for CIVs, ASFONZ suggests that the government’s aim should be to level 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.

ASFONZ thinks that the government needs to decide whether:

- (a) CIVs are 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.

or

- (b) CIVs are 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.

ASFONZ prefers the second “collective” approach mainly because it satisfies the requirements of the “gold standard” test that we proposed in part 1 of this submission.

ASFONZ thinks that the Discussion Document proposes neither and ends up with a more complex regime (than at present) that few will understand²⁹. We also suggest that it will inevitably lead to distortionary, tax-induced investment behaviour.

In our view, the Discussion Document proposes the worst of both worlds.

ASFONZ recommends that we start again. It's not too late.

²⁹ We understand that the introduction of the 39% tax rate in 2000 added 47 pages of legislation to the Income Tax Act. That does not include the numerous subsequent amendments to tidy up the difficulties with the first tranche of changes. We suggest that the proposed QCIV regime will add more than another 47 pages. Our proposed "in principle" approach should significantly reduce existing CIV-related tax legislation. That seems to ASFONZ to be a good thing.