FinancialServicesCouncil.
growing and protecting the wealth of New Zealanders

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Secretariat
Finance and Expenditure Committee
Select Committee Services
Parliament Buildings
WELLINGTON 6160

The Financial Services Council of New Zealand ("FSC") is pleased to make a submission on the Taxation (Annual Rates, Foreign Superannuation, and Remedial Matters) Bill ("the Bill").

The FSC is the industry association for the companies that issue and manage life insurance, superannuation and managed funds in New Zealand. FSC has 23 members and 18 associate members, including KiwiSaver providers, who are collectively responsible for management of over $80 billion in funds under management. FSC life insurance members are responsible for approximately $2 billion in Annual Premium Income and provide personal risk cover worth more than $286 billion.

A list of members is attached.

This submission has one recommendation regarding the taxation of life insurance and then focuses on Part 2 of the Bill, which amends the Income Tax Act 2007 with respect to the taxation of interests in foreign superannuation schemes.

Remedial Changes to the Taxation of Insurance Business
We submit the "present value (actuarial net)" discount rate should also apply for the purposes of sections EY 28 and EY 29 to be consistent with the proposed changes to sections EY 17 and EY 21.

Taxation of Foreign Superannuation
The FSC provided feedback on the Paper published by Inland Revenue and Treasury Officials in July 2012, setting out a proposal for reforming the taxation of foreign superannuation in New Zealand and we remain supportive of the reform. We do, however, have some specific recommendations which we believe would improve the Bill and these are set out below.

Reduce the 5% rate under the schedule method

The proposed schedule method assumes average fund growth in the foreign scheme of 5% post any taxes and fees, and ignoring exchange rate movements. Furthermore, that method imposes a compounding interest charge at 5%. We understand that the 5% rate was chosen to be consistent with the fair dividend rate (FDR) method in the foreign investment fund (FIF) rules.

We submit that a 5% rate is significantly greater than what most funds are realistically returning on a year-by-year basis. Accordingly, use of the schedule method will deem a person to have earned a greater return than is actually the case and, in addition, will impose interest on that figure. A person who makes a nominal return of less than 5% after taxes and fees from their interest in a foreign scheme will be over-taxed, potentially significantly. Both capital amounts and income which accrued before the person migrated will be taxed – that is, the foreign income of a non-resident. This is fundamentally at odds with the scheme and purpose of New Zealand's overall tax system.

Furthermore, FDR is not a valid precedent on which to set the schedule rate. Under the FIF rules, a natural person is able to choose between the FDR and the comparative value methods depending on their overall return across all FIF investments in that income year – i.e. the 5% is a cap rather than an average. This serves to lower the long-run rate of tax to approximately 3.5% of the market value of the FIFs, rather than the 5% prevailing under the FDR method. In addition, under the proposed new rules people will not be able to choose between the schedule and formula methods to achieve a similar result due to the restriction in proposed section CF 3(6)(b)(iv).

Accordingly, we submit FDR is not an appropriate precedent and the 5% rate under the schedule method is inappropriately high. It will frequently result in systematic over-taxation for people who are unable to use the formula method. To ensure the proposed changes are equitable and sustainable for the long-term, the schedule method should be revised to use a lower assumed fund growth (and interest) rate.

If, however, it is still considered that FDR is appropriate as a precedent, we submit the schedule rates should therefore assume fund growth of 3.5% or 4%, which is in line with the long-term rate of FDR. Such a rate would also be more in line with market conditions and would help to prevent over-taxation.

Extend "exemption period" to all residents

It is proposed all new migrants will be exempt from tax on foreign superannuation receipts within the first four years of their residence, irrespective of whether they are a transitional resident. The initial proposal was for a two-year exemption. We support this extension of the exemption period. It properly acknowledges the contribution to the New Zealand economy that new migrants add when they bring their retirement savings here. It should encourage new migrants to transfer their savings to New Zealand and thereby help develop New Zealand's capital markets.

However, the "exemption period" only appears to be available to persons who migrate to New Zealand on or after 1 April 2014. It will not be available to individuals with foreign superannuation interests who are already in New Zealand, or those who will migrate between now and 31 March 2014.

We submit this is unfair and will create inequity between people in similar circumstances depending on when they migrate. Taking the worst case example, a person who arrives in New Zealand on 31 March 2014 after having acquired a foreign superannuation interest while overseas will not receive the exemption period, while a person who arrives a day later will receive the exemption.

This disparity will result in significantly different tax outcomes between those two individuals. For example, if the first person receives a lump sum in year four they will pay tax based on four years of residence. The second person will pay no tax on that lump sum as it would fall within the exemption period. Similarly, withdrawals after the end of the exemption period will also result in large differences in the schedule fractions faced by these two individuals, which will be greatly out of proportion to the one day difference in duration of residence.

The July 2012 issues paper and the regulatory impact statement released in May 2013 strongly implied that the disparity in tax treatment facing people in similar circumstances, and the inequities that result, were a significant driver behind the policy review. We agree that such inequities should be resolved, but consider the current proposals will allow a significant inequity to remain. This should be addressed. In our view, every resident with an interest in a foreign superannuation scheme on 1 April 2014 should receive the four-year exemption period. Such a provision would address the above inequities and also greatly encourage the repatriation of offshore capital to New Zealand which would be good policy from a New Zealand perspective enabling such foreign superannuation fund transfers to be invested into income earning New Zealand funds

Penalties and interest on past withdrawals

With regard to past withdrawals for which a person did not comply, it is proposed a new due date will apply for tax payments made under the 15% partial amnesty option. The new due date will be the person's terminal tax date for the income year in which they include the income in their tax return, or for the 2014/15 year if later. This will ensure that shortfall penalties and use-of-money interest are not imposed due to the previous non-payment of tax on the lump sum.

We agree with the revised due date but submit that it should also be extended to people who choose to return an amount of income under the law which existed at the time of the lump sum was received, rather than only under the 15% option.

In many cases, the people at whom the proposed partial amnesty is targeted withdrew their retirement savings in the early- to mid-2000s – i.e. before the introduction of the transitional residents' rules in April 2006. The majority of these people would not be able to have the entire amount treated as a return of capital and would, therefore, be expected to face a tax liability. Imposing penalties and interest compounding monthly or daily, as the case may be, over a period of potentially ten years or more will likely be punitive. We would expect that such charges would greatly outweigh the core tax at stake for many.

In effect, this is retrospective lawmaking. By making the existing law option prohibitively expensive due to the imposition of penalties and interest, such people are being left with no choice at all but to apply the 15% option rather than the prevailing law.

Inland Revenue has admitted that the complexity of the current rules has contributed to the non-compliance.[1]

Waiving the imposition of penalties and interest for all residents until the terminal tax date for the 2014/15 income year would encourage more people to seek to comply with their tax obligations. This is in line with Inland Revenue's objective to increase voluntary compliance and raise revenue while acknowledging the department's contribution to the current situation.

Application of the provisional tax rules

We are concerned that individuals will fall into the provisional tax rules as a result of receiving a lump sum foreign superannuation payment if their residual income tax in the year of receipt exceeds $2,500.

The stated intention of the policy review is to develop a set of rules which is simple and easy to comply with. This is, for example, the rationale behind the design of the schedule method. We agree that simplicity is an appropriate goal given that most new migrants – especially persons nearing or in retirement – may be expected to have only a limited understanding of tax law.

[1] Inland Revenue issues paper, July 2012, p.20, para 4.2.

Accordingly we submit lump sums received from a foreign superannuation scheme should be excluded from the criteria to comply with the provisional tax rules. That is, the $2,500 threshold in section RC 3(1)(a) should apply to a person's residual income tax liability for a year ignoring tax payable under section CF 3 on their foreign superannuation withdrawal.

Recognising FIF tax already paid

The new rules will impose tax on a lump sum received from a foreign superannuation scheme under one of two new methods. The formula method explicitly takes into account past income received from a particular foreign superannuation interest, as well as (separately) tax paid on that income. However, assessable income does not only arise from prior withdrawals. It can also arise under the FIF rules.

There is no mechanism in the proposed new rules by which FIF income previously returned – and, correspondingly, any tax on that FIF income – with regard to a particular foreign superannuation interest is recognised. That is, there will be no credit for tax already paid. This will lead to double taxation.

For example, a person migrated to New Zealand in 2006 and became a transitional resident. They applied the FIF rules from the end of the transitional residents' exemption (say, the 2011 income year) until 2020. In that year, they do not return FIF income or loss for whatever reason, and so cease to be grand parented under the proposed new rules. When they withdraw their foreign superannuation in 2025, they will be required to pay income tax based on 14 years of residence (since ceasing to be a transitional resident). There is currently no proposal to enable Inland Revenue to recognise the ten years of FIF income. From 2011 to 2020, therefore, they are taxed on deemed income under the FIF rules and taxed again on that income on receipt.

We submit there should be a credit for tax on FIF income paid in prior income years. We outline two potential ways in which to do this:

- Allow a deduction for tax on FIF income already paid with respect to that foreign superannuation interest, as done in the formula method for tax paid on previous withdrawals.
- Commence a person's "years of residence" from the start of the income year following the year in which they last return FIF income from that foreign superannuation interest. As gains prior to that point have already been taxed under the FIF rules, this option would mean that only gains since that date are taxed on receipt.

Not providing a mechanism whereby FIF tax previously paid is creditable – or otherwise recognised – will lead to double taxation. This is not merely hypothetical but will impact people who have stopped returning FIF income.

Extend formula method to defined benefit schemes

Under section CF 3(6)(b), the formula method will only apply to withdrawals from defined contribution schemes. We understand this restriction was put in place because of the risk of and uncertainty associated with valuations of defined benefit schemes. The effect of this restriction is that all residents with interests in defined benefit schemes will be required to use the schedule method.

We submit the restriction to limit the formula method to defined contribution schemes should be removed. The formula method should apply to all foreign superannuation schemes for which the person has the information required to use that method. We note that actuarial valuations of interests in defined benefit schemes are available and they are a recognised means of valuing interests in such schemes. Inland Revenue have generally accepted actuarial valuations when, for example, a person applies the FDR method under the FIF rules, which requires a market valuation.

If a person is willing to pay to obtain an actuarial valuation of their interest in a defined benefit scheme, this should be sufficient to satisfy the information requirements required under the formula method.

"Recognised contributions" is too restrictive for formula method

The proposed formula method is designed to determine the percentage of New Zealand-sourced gains to the total value of the foreign superannuation interest at the time of withdrawal, and apply that same percentage to the value of the withdrawal to determine the taxable distribution. To do this, the formula in section CF 3(11) subtracts contributions which meet the criteria to be a "recognised contribution" in section CF 3(16).

The criteria for a recognised contribution are largely consistent with the proposals in the issues paper with regard to the schedule method. However, we submit that the same criteria are inappropriate for the formula method. As the section CF 3(11) formula is merely to determine the correct value of New Zealand-sourced gains, *all* contributions should be subtracted in that formula if they were made while the person is a New Zealand resident. Not subtracting voluntary contributions will result in the section CF 3(11) formula treating those as gains and therefore allocating too high a percentage to the lump sum amount.

Consider a simple example. A person has a transit value at the end of their exemption period of \$50,000. They withdraw the entire amount ten years later when the value of the interest is worth \$90,000. During that ten year period, they made compulsory contributions of \$3,000 and voluntary contributions of \$7,000 (a total of \$10,000).

The formula in section CF 3(11) would work as follows:

$$\frac{\$90{,}000 + \$0 - \$50{,}000 - \$3{,}000}{\$90{,}000} = \frac{\$37{,}000}{\$90{,}000} = 0.4111$$

Applying the 0.4111 "calculated gains fraction" to the value of the foreign superannuation withdrawal of \$90,000 gives taxable gains of \$37,000. The person will pay tax at their basic tax rate on this amount (plus the interest component in section CF 3(14)). However, they have only earned New Zealand investment returns of \$30,000, being \$90,000 less \$50,000 transit value less \$10,000 contributions.

We understand that there was a risk with the schedule method that allowing a deduction for all contributions would lead to the double counting of contributions – once explicitly as a deduction, and once implicitly as the schedule rates allocate amounts between taxable and non-taxable amounts. This risk is not applicable under the formula method. If the \$7,000 of contributions are not able to be subtracted, they will not be deducted otherwise and, therefore, will be treated as taxable despite their capital nature. This is inappropriate.

We submit the criteria to be a recognised contribution, as per section CF 3(16), should not apply to contributions to be deducted under the formula method. Instead, the section CF 3(11) formula should apply to all contributions made while a person is New Zealand resident.

Deborah Keating
EXECUTIVE OFFICER

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