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 (Livestock Valuation, Assets Expenditure, and Remedial Matters) Bill ("the Bill").

This submission specifically focuses on clause 33 of the Bill relating to changes to remove the mismatch in the tax treatment of foreign currency hedges and certain offshore shares held by investment vehicles ("FDR for hedges regime").

The FSC represents investment and life insurance companies in New Zealand. Its objectives are to represent the interests of New Zealand financial services industry as well as the wider interests of all New Zealanders. Members of the FSC manage more than $80 billion in savings and provide financial services to more than 1,800,000 New Zealand investors and policyholders.

The FSC strongly supports the new regime which aligns the tax treatment of foreign currency hedges with the tax treatment of the underlying assets being hedged. The new regime is designed to remove tax as an obstacle to effectively hedging a portfolio of overseas equities. However, in order to achieve this, the rules need to be drafted so that they fit with how funds are typically structured and operate in practice. The implementation of the rules efficiently and effectively is important so that costs are kept at a minimum.

This submission addresses ways in which the regime can be amended to allow ready and practical application to achieve the desired policy objective.

We would be happy to talk to Officials regarding the technical issues of our submission if the Committee considers it appropriate.

Further information

The FSC would like to make oral submissions in support of its position. Please do not hesitate to contact Deborah Keating on (04) 831 0308 to confirm our attendance or if you have any questions on the submission.

Yours sincerely,

Deborah Keating
EXECUTIVE OFFICER

Submission

The Financial Services Council of New Zealand ("FSC") supports the intent of the fair dividend rate for foreign currency hedges regime ("FDR for hedges regime") contained in clause 33 of the Taxation (Livestock Valuation, Assets Expenditure, and Remedial Matters) Bill ("the Bill").

However, the FSC is concerned that the way the policy is being implemented will make it difficult for funds to apply the rules so the policy objective is achieved.

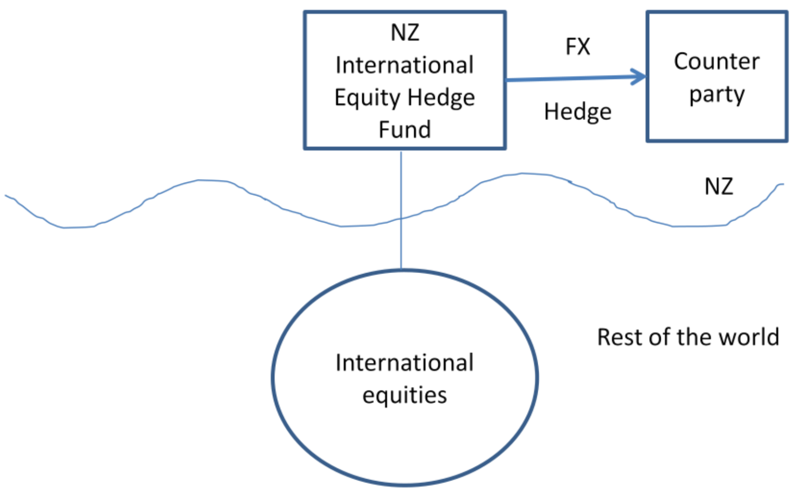
1 Overview of the funds industry

Funds will offer investors the ability to hedge FX currency movements arising from international investments. This offering is usually transparent and discoverable as it is outlined in investment statements and prospectuses. A series of controls are in place, such as regulations, independent trustees and trust deeds, to ensure that a fund acts consistently with those statements and that the hedge transactions are entered into at arm's length.

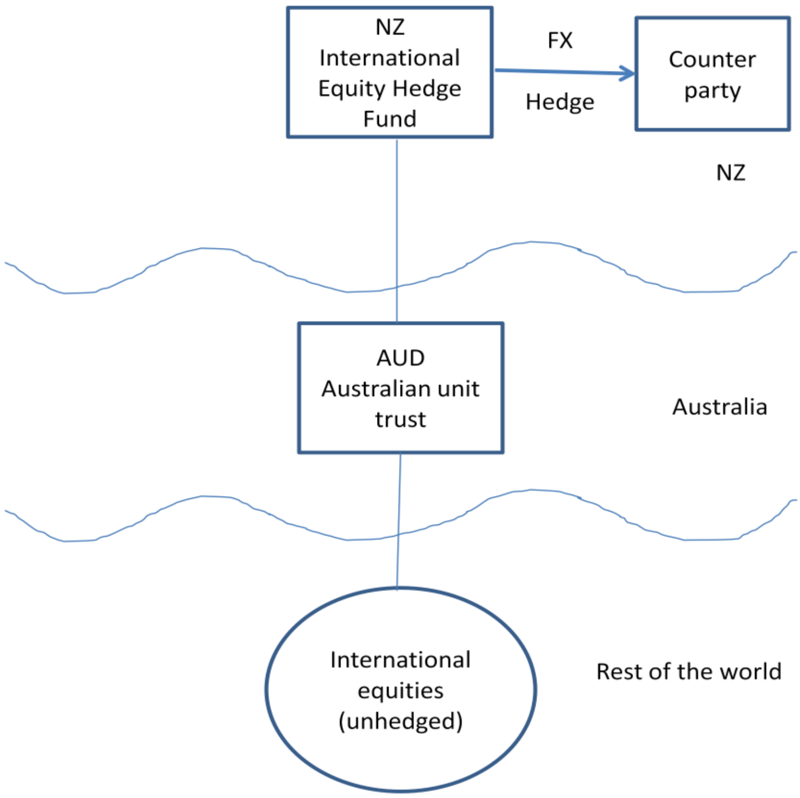
1.1 Common fund structures

The actual hedging of FX currency movements is achieved in a number of different ways. These methods aim to minimise compliance and transaction costs and simplifies the investment process for investors. We outline below four typical examples of such offerings:

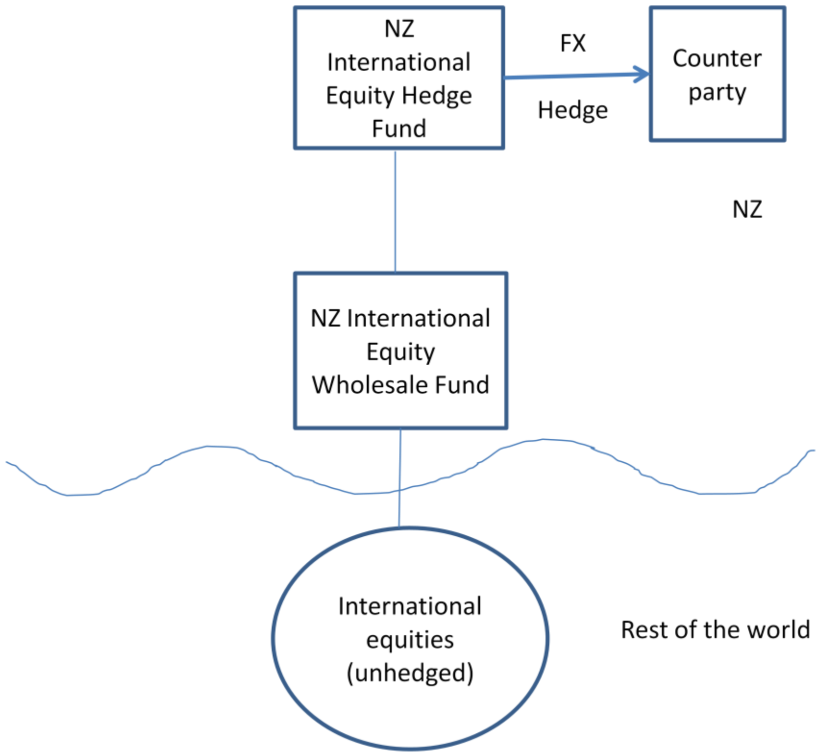
(1) A New Zealand single sector fund that invests directly and solely into international equities and hedges directly:



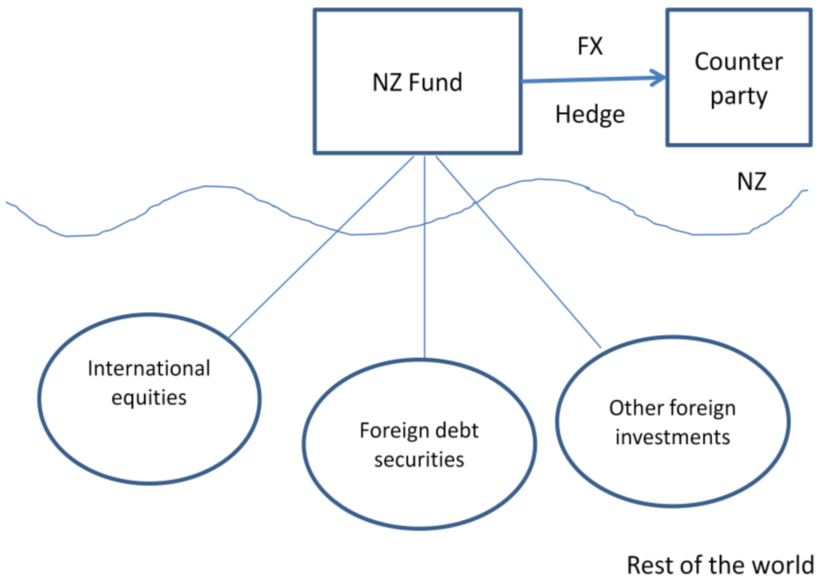
(2) A New Zealand fund that invests into international equities via an Australian unit trust and hedges the underlying FX currency movements directly rather than the hedge occurring within the Australian unit trust:



(3) A New Zealand fund that invests in international equities via one or more New Zealand funds where equity investments are held in one fund and hedging is done in another:



(4) A New Zealand mixed fund with multiple asset classes where international equities are one asset class and a hedge is entered into directly to hedge FX exposures from that asset class:



1.2 Structure of our submission

The FDR for hedges regime, as drafted, deals with the fourth example above. We agree that the regime needs to be comprehensive as a result. However, we consider that it would be difficult, from a practical perspective, to apply the regime to the first three scenarios.

We consider that the introduction of a stand-alone FDR Hedging Fund regime would solve many of the practical complexities and difficulties that the rules as drafted would give rise to in the first three scenarios; in particular, the "out of fund" hedging scenarios in the second and third examples.

We have also identified specific issues in the current proposals which we have considered in detail and submit on extensions to the current proposal.

As such, our submissions are in three parts:

(1) Introduction of a new FDR Hedging Fund to apply the proposals effectively and minimise compliance costs;

(2) Improvements to the current proposals so that they more efficiently achieve the policy objectives as we understand them; and

(3) Extensions to the proposals so that they can apply to equivalent situations which should be taxed in the same way.

2 Introduction of a new FDR Hedging Fund

2.1 Submission one

We submit that a new FDR Hedging Fund (similar to the foreign investment PIE model) should be introduced. Such a Fund would effectively apply a portfolio approach to their hedges.

Comment

The FDR for hedges regime is complex and attempts to deal with the many ways that funds invest in practice. The majority of those who would want to be able to apply the rules are in fact single sector funds which only invest in one asset type (i.e. international equities and Australian equities). A simpler approach would be to define the types of funds which can make use of the rules where they hold a de-minimis amount of other investment assets such as cash.

The introduction of a new FDR Hedging Fund would also remove the necessity to make an election and calculate the FDR hedging portion for each individual hedge.

2.2 Submission two

We submit that for a Fund to be a new FDR Hedging Fund, the following criteria need to be satisfied:

- The Fund must predominantly hold, directly or indirectly, international equity investments that apply the FDR method, Australian non-attributing shares or ASX listed New Zealand shares and the associated hedges which are entered into to hedge the currency risk;
- Less than 5% of total investments of the Fund can consist of international investments that apply the comparative value approach instead of FDR;
- The Fund may hold cash of less than 5% of total assets of the Fund;
- The Fund must be of a type covered by section EM 2.

The test for the above criteria should be applied quarterly, similar to foreign investment PIEs.

Comment

A New Zealand fund as outlined in scenarios one, two and three in the earlier examples would readily qualify as a FDR Hedging Fund.

2.3 Submission three

We submit that the following sections would not apply to a FDR Hedging Fund:

- Section EM 4 – individual elections would not be required;
- Sections EM 3, EM 5, EM 6 and EM 7 –eligibility tests and income calculations for individual hedges would not be required.

Comment

If this submission is accepted, subpart EM will need to be amended to include provisions to accommodate a FDR Hedging Fund. We would be happy to discuss the technical issues regarding the provisions with Officials if the Committee considers it appropriate.

3 Focus on current proposals in the Bill

FSC members manage many of the funds which would seek to apply the FDR for hedges regime. Our members have experience of how the funds are established and operated in practice.

We consider that a FDR Hedging Fund would simplify the application of the regime and address the issues we have identified with the rules as drafted. However, if this submission is not accepted, we outline below our submissions on amendments required in the rules to ensure they can practically be applied. These submissions focus on simplifying and clarifying the proposals.

3.1 "Out of fund" hedging

Submission

We submit that subpart EM is amended to allow "out of fund" hedging to qualify for the FDR for hedges regime where the purpose of the hedge is to hedge the underlying currency exposure of a FIF investment held by a fund directly or indirectly. This can potentially be achieved by:

- amending the definition of "proxied currency asset" to include situations where the purpose of the hedge is to hedge a currency exposure of an underlying or indirect FIF investment;
- amending the definition of "eligible hedge" in section EM 3 to refer to the "underlying" currency rather than "denominated" currency; and/or
- allowing an investment in an FDR Hedging Fund to be hedged (discussed at section 1.1 above).

Comment

The rules as drafted apply to hedges that (among other requirements):

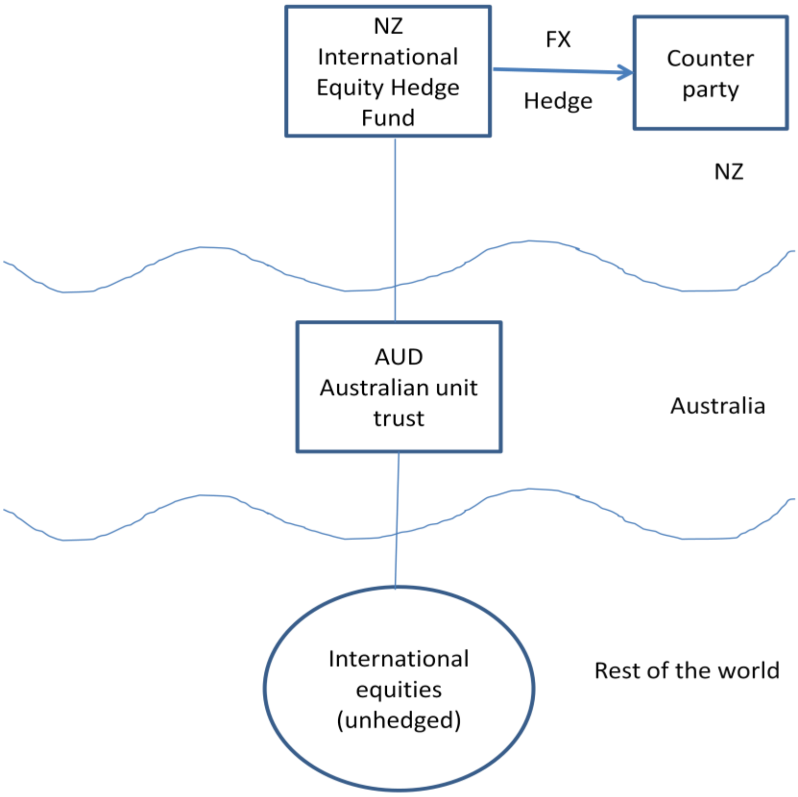
- hedge attributing interests in a foreign investment fund ("FIF") (section EM 1(1)(b)); and
- are a contract to conditionally or unconditionally acquire or dispose of foreign exchange in return for New Zealand currency (section EM 3(a)); or
- have one leg denominated in a foreign currency and the other leg denominated in New Zealand currency (section EM 3(a)).

The effect of these requirements is that the FDR for hedges regime will apply to "in fund" hedging, i.e.:

- hedges that are hedging FIFs held directly by the fund ("in fund" hedging); and
- hedges that hedge the currency of the FIF investment.

This will mean that the rules cannot be applied to certain "out of fund" hedging situations where the hedge is held by a New Zealand fund and the international equity exposure is via another vehicle (examples from above repeated below).

<u>Scenario two</u>



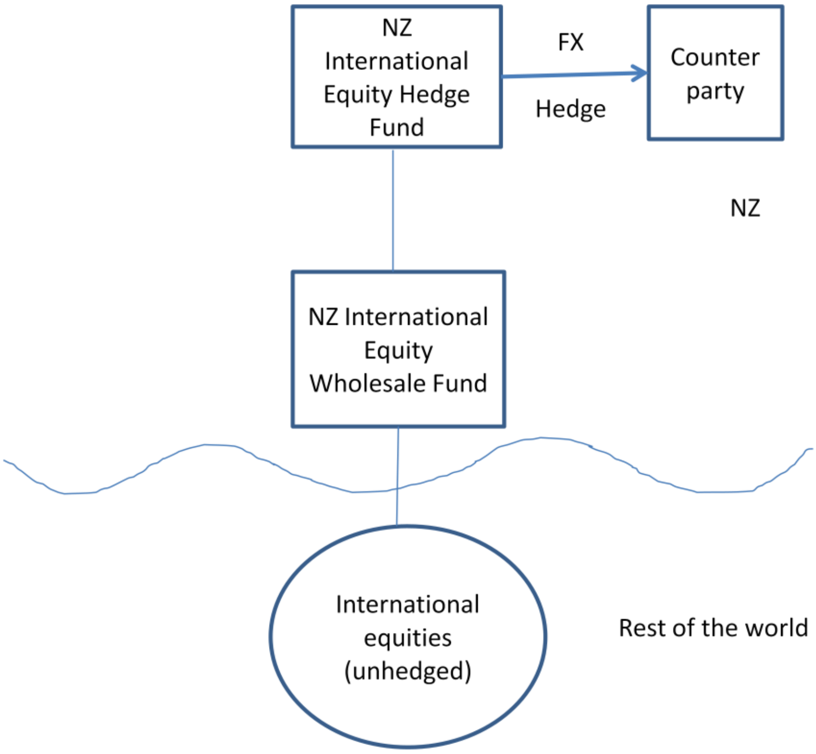
In this scenario, a New Zealand fund invests into international equities via an Australian unit trust. The New Zealand fund hedges the underlying foreign currency movements directly (e.g. NZD and USD), rather than entering into two separate swaps (e.g. NZD and AUD, AUD and USD).

As drafted the New Zealand fund would not qualify to apply the hedging rule as it does not hold the international equities directly. However, it derives its taxable income from the international equities.

Further, the hedge would be denominated in the currency of the underlying international equities and not Australian dollars. Under the draft rules, the hedge would not be an eligible hedge as an AUD hedge may not be an appropriate proxy for the USD exposure of the fund.

However, this fund's position should be the same as if it invested directly.

Scenario three



At its simplest, a NZ sector fund (e.g. NZ International Equity Wholesale Fund) invests into international equities. A New Zealand fund (e.g. NZ International Equity Hedge Fund), marketed as a hedged fund, invests into the NZ sector fund. As drafted, this New Zealand fund would not qualify to apply the hedging rule as it does not hold the international equities. However, it derives its income from the international equities. Its position should be the same as if it invested directly.

There are a number of commercial reasons for such a structure, including:

- to offer different entry points to allow wholesale and retail investment for example; or
- allow a NZ fund to adopt a different hedging policy if the NZ sector fund is only partially hedged; or
- to minimise transactions in the underlying equities.

The first and third submissions would address this common scenario.

3.2 Section EM 2(1) – Eligible persons

Submission

We submit that section EM 2(1) is amended to include profit participating policies (“PPPs”).

Comment

As currently outlined in section EM 2, the FDR for hedges regime will only apply to separately identifiable funds of a life insurer where the benefits are directly linked to the value of investments held in the fund. For life insurers who hold their investment assets within the life insurer, this will mean that the new rules will only apply to their unit linked savings products. It will not apply to PPPs.

Because PPPs are not within the rules, this may make it difficult for insurers to apply the proposed rules where investment assets supporting both types of policies are managed on a pooled basis within the life insurer. Given most PPPs and unit link policies are closed to new business due to most life insurers now only issuing risk business, allowing the proposed rules to apply to investment assets held to support PPPs should be allowed. Also the investment income from international shares attributable to PPPs is also taxed on the same basis as unit linked business.

While the shareholder base is allocated a share of investment income from PPPs (due to the nature of PPPs), this proportion is generally small (less than 20%). Therefore, allowing the new rules to apply to PPPs and unit linked business would result in a simplification of the rules for life insurers and make them more practical to apply. This could be achieved by amending EM 2(1) to also include PPPs.

Where the life insurers holds international equities to support its shareholder base only, then the new rules should not apply.

3.3 Section EM 3(c) and (d) – Associated persons and fair value requirements

Submission

We submit that section EM 3(c) and (d) are repealed and replaced with a requirement that a hedge is entered into at arm's length.

Comment

Section EM 3 outlines the criteria for an eligible hedge, including that a hedge must not be entered into with an associated person (EM 3(c)) and the hedge has, under IFRSs, a fair value of zero when it is first entered into (EM 3(d)).

<u>Associated persons</u>

The associated persons restriction is problematic for a life insurer which is part of a group with a bank. The rules would preclude genuine transactions from qualifying for the FDR for hedges regime. We understand that paragraphs (c) and (d) have been included as precautionary measures (e.g. to prevent non-market hedges, entered into with an intention to shift profits, from qualifying).

However, investment funds are already subject to a raft of rules and regulations such as prudential requirements to act in the best interests of investors or policyholders of life insurers and to also ensure that investments made are consistent with prospectus and other investment statements. Independent trustees for managed funds are also in place to ensure that transactions are entered into at market. Further, trust deeds for managed funds generally preclude non-market hedges from being entered into. For life insurers, the requirements of the Insurance (Prudential Supervision) Act for directors to give priority to the interests of policyholders should also ensure that transactions are conducted on arm's length commercial basis where transactions are with related entities.

Commercially, it is also unlikely that the managed fund would enter into a transaction to transfer profits to a counterparty to a hedge as they are economically separate.

The associated persons rule is not required in the context of regulated investment funds and life insurers.

<u>Fair value of zero</u>

We consider that requiring all hedges to be entered into on arm's length commercial terms would be a sufficient precautionary measure. There are situations (see section 3.4, scenario two) where a hedge will not have a nil value at inception but will still be at arm's length. Requiring non-associated persons and a fair value of zero at inception would preclude bona fide market hedges to be eligible hedges under the new rules.

3.4 Hedge of a hedge scenarios

Submission

We submit that the rules are amended to ensure that a hedge that is entered into to hedge an eligible FDR hedge falls within the FDR for hedges regime.

Comment one

It is common industry practice to achieve partial termination of a hedge contract through the use of an equal and opposite hedge transaction. It is also possible that funds would enter into a hedge contract to extend the term of the hedge.

Scenario one

A FX contract for US$10m is entered into to hedge investment assets, but the hedged investment assets then reduce to US$9m due to a large redemption. Rather than terminate the existing USD hedge, the fund enters into a new hedge contract for the opposite exposure of US$1m to ensure its net hedge position remains at US$9m for the remaining term of the initial contract.

These hedges need to be part of the regime otherwise a mismatch of tax treatments, would arise as the second hedge would be taxed under the financial arrangement rules. It is not clear from the Bill that such hedges are eligible hedges and that the formulae do not exclude such hedges from the calculations.

Comment two

Scenario two

A historic rate roll for an FX contract is undertaken to spread a contract loss for a further term beyond an original FX contract. This transaction, at inception, should have a value equal to the value of the original hedge. This is because the value of the original contract is being repaid over the life of the new hedge.

It is unclear whether such hedges would fall under the rules. However, we submit that the rules should be clarified so that these hedges clearly do.

A historic rate roll is usually done to manage the cash flows of a fund rather than to trade in the hedge. If the hedge is not subject to the FDR for hedges regime, a tax loss will arise given that the hedge is expected to be a loss.

Allowing hedges of hedges to qualify would achieve the outcomes intended by the regime.

3.5 Section EM 4 – Election

Submission

We submit that section EM 4 is amended to allow election on a generic or portfolio basis, rather than only on an individual hedge basis. Such generic elections can be made (or revoked) for all hedges on a portfolio basis by way of an election in writing to Inland Revenue.

Comment

Under the draft legislation, a fund that wishes to apply the new rules must elect for each individual hedge to be subject to the new rules at the time it is entered into. The requirement that an election is required for each individual hedge will be a compliance intensive process and overly burdensome.

It would require significant changes to multiple systems and many of the systems are automated due to the number of transactions processed on a day to day basis. This increases the risk of errors and also compliance costs in implementing the legislation. A generic election would mean that many of these systems may not be impacted or require change.

A hedge contract may need to be recorded and dealt with by multiple parties within a fund. It is not unusual to have separate investment managers, custodian and administrators involved in a fund's investment activity. Individual elections will need to be handled by each of these parties to ensure that the FX contract is appropriately and correctly dealt with.

Most of the funds (and life insurers) which would wish to apply the FDR for hedges regime are likely to be funds which have a formal hedge policy which applies to all hedges that are entered into with no discretion allowed. This will often be detailed and discussed in the prospectus and disclosure statements provided to investors or policyholders.

Accordingly, most, if not all the hedges they enter into will be for this purpose. A formal, generic election covering all hedges entered into from a specified date would reduce their compliance costs and reduce the chance of error.

We recommend that the election is made once in writing to Inland Revenue. We note that a fund would be able to elect specific contracts to not be qualifying hedges. However, that is likely to be rarer and more easily handled by the various parties.

3.6 Section EM 4(2) – Irrevocable election

Submission

We submit that an exception is included in section EM 4(2) for genuine election errors.

Comment

Under section EM 4(2), an election to apply the FDR hedge rules to a particular hedge is irrevocable. We envisage there could be situations where elections are mistakenly made due to, for example, a miscommunication between the fund administrator and the fund manager, or a processing error.

As such, we recommend that an exception is included in section EM 4 to allow an election to be revoked provided it was due to a genuine error. A proviso should be included to restrict the ability to revoke to within 90 days after the end of the quarter in which the incorrect election or administrative error was made.

3.7 Section EM 5 – Application of formulae on individual hedges

Submission

We submit that section EM 5 is amended to allow the formulae to be applied across a portfolio of hedge assets and not just on an individual hedge basis.

Comment

The formulae contained in section EM 5 to calculate the maximum FDR hedge rate portion for an eligible hedge is required to be applied on a hedge by hedge basis. From a practical perspective, implementation of this would be incredibly time consuming. We submit that section EM 5 is amended to allow the formulae to be applied across a portfolio of hedge assets and not just on an individual hedge basis.

3.8 Section EM 5 – Proxy hedge rules

Submission

We submit that items (ii) and (iii) of section EM 5(5)(b) are repealed.

Comment

The FDR for hedges regime allows for proxy hedging where a hedge in one currency is used to hedge exposures in another currency. The broad requirement under the regime is that the proxy hedge must act like a hedge of the FIF investment.

Proxy hedging is common in the funds industry as it is impractical to hedge every currency that a fund is exposed to. Further, funds may need to enter into proxy hedges due to the limited market for hedge counterparties for a particular currency.

For example, a fund might hedge a Brazilian Real equity investment with an NZD/USD foreign exchange ("FX") contract. The USD movement is considered to be a proxy for the Brazilian Real movement.

The FDR for hedges regime incorporates the concept of proxy hedging by including "proxied currency assets" in the calculation of the FDR hedge rate portion for an eligible hedge. However, the definition of "proxied currency assets" is overly restrictive as currently drafted and has the effect of defeating the policy intent of the rules.

<u>Item (ii)</u>

Under item (ii) of section EM 5(5)(b), the value of a "proxied currency asset" is zero if the person has hedges denominated in the proxy currency.

From a practical perspective, funds are likely to have hedges denominated in the proxy currency given that the fund is likely to have equity investments denominated in the proxy currency. Using the currencies above, as an example, the fund is likely to have USD equity investments hedged by USD FX contracts.

The effect of item (ii) of the definition is that a significant number of proxy hedges would be precluded from the FDR for hedges regime, which is inconsistent with the policy intent of the regime. Accordingly, we submit that section EM 5(5)(b)(ii) is repealed.

<u>Item (iii)</u>

Under item (iii) of section EM 5(5)(b), the value of a "proxied currency asset" is zero if a person has a hedge denominated in a currency other than the proxied currency or the calculation currency, that "acts like hedging for the assets due to a relationship between exchange rate movements in the proxied currency and that other currency".

In practice, a fund may consider more than one currency as a proxy currency for a particular currency. This may occur because a perfect proxy hedge relationship does not exist for any one proxy currency. As such, commercially, funds may enter into more than one proxy hedge to minimise exposures from a currency arising from the FIF investment.

Item (iii) of the definition would prevent such proxy hedges from being included in the FDR for hedges regime. As the intention and effect of such arrangements is simply to hedge the underlying currency exposure from the FIF investment, we consider that the regime should not exclude these scenarios. Therefore, we submit that section EM 5(5)(b)(iii) is repealed.

The control for a hedge to qualify as a proxy hedge under the FDR for hedges regime is that it must act like a hedge for the FIF investment (as outlined in section EM 5(5)(b)(i)). This is a question of fact and judgment and should be sufficient to exclude proxy hedges that are not intended to fall within the regime.

3.9 New Zealand shares acquired on the ASX and valued in AUD

Submission

We submit that subpart EM (by amending section EM 1) is extended to include New Zealand shares that are acquired on the ASX and are valued in Australian dollars ("AUD").

Comment

The rules as currently drafted do not specifically contemplate New Zealand company shares that are listed on the ASX that are valued in AUD. It is not uncommon for funds to hold such investments and hedge the AUD movements. The rules should not exclude such hedges from applying the FDR for hedges regime simply because the shares are New Zealand companies. As such, the rules should be expanded to include hedges of such investments.

3.10 Section EM 7(4)

Submission

We submit that in section EM 7(4), 5 days is amended to 5 "working" days.

Comment

This is a minor amendment to ensure that weekends and public holidays are not included in the 5 day timeframe.

4 Expanding the ambit of the Bill

Our submission and comments in this section focus on expanding the ambit of the current Bill.

4.1 Section EM 1(1)(b)(iii) – Unit valuation period

Submission

We submit that section EM 1(1)(b)(iii) is expanded to include unit valuation periods of greater than one day (e.g. weekly and monthly valuation periods).

Comment

The proposal should be expanded to include widely-held investment vehicles with a FDR unit valuation period of greater than one day. We understand from discussions with Officials that the restriction is intended to ensure that a taxpayer cannot choose to apply the FDR for hedges proposal to hedges that are entered into and "closed out" inside a single valuation period. The example below illustrates:

If an entity has a quarterly FDR unit valuation period and it enters a one month hedge in the middle of a quarter, there would be no hedge to value at the opening of the quarter or the opening of the following quarter. Accordingly, no taxable income or expenditure would arise in respect of that hedge, under the proposal (whereas the hedge gain or loss would be taxable under the current financial arrangements rules).

We recommend expanding the eligibility requirement in new section EM 1(b)(iii) to include entities with weekly or monthly FDR unit valuation periods, provided all hedges elected into the proposal are for a term that is longer than the entity's FDR unit valuation period. This should ensure that any hedge value is picked up in the tax calculation for the following period.

END OF SUBMISSION