



Niels Campbell Partner

## Significant changes planned for taxing offshore investments

### Revised rules

The Government has released details of a revised set of rules for the taxation of investment income of New Zealand investors. The scope of the proposed rules have been the subject of much debate since they first appeared in a discussion document released in June last year.

The proposed rules significantly change the way that offshore investments held by New Zealand investors are taxed and introduce a new regime for Qualifying Collective Investment Vehicles.

### 85% capital gains tax on most offshore portfolio investments

The revised rules will tax 85% of all capital gains on portfolio investments (investments of less than 10%) in foreign companies (with the exception of investments in Australian companies listed on the ASX) on an unrealised basis if the original cost of the investor's portfolio exceeds NZ\$50,000.

Investors will be taxed on 85% of the growth in value of their investment and any dividends, although the investor's tax liability will be spread across a number of years. Each year the investor will be required to pay tax on up to 5% of the value of the investment at the start of the year if the

investor receives less than a 5% dividend return. On realisation, the investor will be required to pay tax on the portion of the 85% growth in value that has not previously been taxed if the funds are brought back to New Zealand. However, rollover relief will allow investors to sell one offshore "asset" and purchase another without being taxed in that year on any carried forward gains that have not yet been taxed. It is not clear whether rollover relief would be available if the investor sold an offshore investment and purchased foreign real property (or other property not covered by the proposed rules).

A decrease in the value of an investment will be recognised as a loss for tax purposes in the same manner as gains are recognised as income.

### Pooling offshore investments

Investors will be able to pool their offshore investments for the purposes of the new rules rather than applying the rules to each individual investment.

Nevertheless, investors will still be required to value their offshore investments at the beginning of the year to calculate the 5% cap for that income year.



**Graeme Smail** Partner



**Mathew McKay** Senior solicitor

## **Alternative methods**

### *Branch equivalent method*

The branch equivalent method will continue to be available to investors as an alternative to the new rules. Under this method, profit or loss in the foreign company (calculated under New Zealand tax rules) is attributed to the investor in proportion to their interest in the company.

Investors applying the branch equivalent method under the current rules are not taxed on gains on the sale of their investments.

Applying this method can be a difficult task for portfolio investors from a compliance perspective. It requires that an investor has access to detailed information about the offshore company in order to calculate New Zealand equivalent income or loss.

The Government also indicated that a simplified branch equivalent calculation method may be available for investors in "early stage" companies.

### *Other methods*

In addition to the 5% cap and branch equivalent methods a "85% comparative value method" and standard rate of return method will be available. Like the 5% cap method, changes in value are taxable on an unrealised basis under both of these methods.

## **Exemption for Australian listed companies**

Investors will not be required to apply the new rules to investments in Australian companies listed on the ASX (the cost of those investments are also excluded from the \$NZ50,000 threshold). This may also include listed unit trusts deemed to be companies for New Zealand tax purposes.

The Government has offered no explanation for limiting the exemption to investments in Australian *listed* companies only. Drawing a distinction between listed and unlisted companies can only distort investment decisions and create a bias in favour of larger listed companies.

## **Structuring opportunities**

It may be possible to structure investments to limit the impact of the new rules. For example, portfolio investors could pool offshore investments in a New Zealand holding company which would then invest in a controlled foreign company resident in a grey-list country.

## **QCIV regime**

### **"Flow-through" tax treatment**

Currently, managed funds are taxed on income at 33%. A managed fund that elects to be a qualifying collective investment vehicle (QCIV) will be given "flow-through" tax treatment. QCIVs will be required to pay tax on an investor's share of QCIV income:

- at 19.5% if the investor earned less than \$48,000 in the previous year; and
- at 33% for all other investors.

This will be a final tax for investors in most cases. Investors taxed at 39% will benefit from a 6% tax saving.

### **Exemption for gains on sale of shares**

Gains derived by a QCIV (currently taxed at 33%) on the sale of shares in New Zealand companies and listed Australian companies will be exempt. The exemption will allow investors in QCIVs to receive tax-free capital gains on the sale of those shares.

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For further information, please contact your usual Bell Gully advisor or:

#### AUCKLAND

**Niels Campbell**

niels.campbell@bellgully.com  
64 9 916 8944

**Joanne Hodge**

joanne.hodge@bellgully.com  
64 9 916 8942

**David Simcock**

david.simcock@bellgully.com  
64 9 916 8945

**Willy Sussman**

willy.sussman@bellgully.com  
64 9 916 8952

**John Bassett**

john.bassett@bellgully.com  
64 9 916 8946

**Bridget Forbes**

bridget.forbes@bellgully.com  
64 9 916 8709

**Graeme Olding**

graeme.olding@bellgully.com  
64 9 916 8792

**Mathew McKay**

mathew.mckay@bellgully.com  
64 9 916 8329

**Monique Mackie**

monique.mackie@bellgully.com  
64 9 916 8751

#### WELLINGTON

**Graeme Smail**

graeme.smail@bellgully.com  
64 4 915 6995

**Fiona Heiford**

fiona.heiford@bellgully.com  
64 4 915 6838

**Paul Kilford**

paul.kilford@bellgully.com  
64 4 915 6744

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## Offshore investments

QCIVs will have to use the 85% comparative value method to calculate tax on offshore investments that are not investments in listed Australian companies.

## Qualifying funds

Broadly, a managed fund can elect to become a QCIV if the fund:

- carries on the principal activity of providing savings and investment services;
- is widely held;
- is a portfolio investor (subject to limited exceptions);
- has issued one class of units (this will need to be determined having regard to applicable definitions in the current tax rules); and
- is tax resident in New Zealand.

Defined benefit superannuation schemes will also be able to elect into the new regime.

## Notional wind-up on entering regime

At the time that a managed fund makes an election to enter the regime, the fund will be deemed to dispose of its assets and reacquire them at market value for tax purposes. For most funds, this deemed disposal will trigger a tax liability on investments held by the fund. This tax liability can be spread over three income years.

## What next?

The revised proposals are expected to be included in a new tax Bill to be introduced in May this year. There will be opportunities to make submissions when the Bill is before the select committee. If implemented, the new rules will apply from 1 April 2007.