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PIEs and how to decide whether you want one

The Government has proposed significant changes to the way in which share investors who invest through an entity (as opposed to investing in the shares directly) are taxed. Under the proposed legislation, individuals who invest through a portfolio investment entity (**PIE**) will be taxed at either 19.5% or 33%, (never 39%) depending on their preceding year's income.

Generally, PIEs will be able to derive capital gains from New Zealand shares and Australian shares listed on the ASX on a tax-free basis and able to pass these gains through to individual investors, tax-free. This is not the case for other investments made by PIEs.

Deciding whether to become a PIE will therefore be an important question facing collective investment vehicles. The requirements to become a PIE and the implications for investors are explored below.

Electing in and out

An entity can elect to be a PIE by giving notice to the Commissioner of Inland Revenue. In the first year (2007-08) an entity will be able to elect into the PIE rules with effect from the start of each quarter following the date notice is given. Where an election is received after 1 January 2008, it

will be effective at the start of the next tax year.

An entity may choose at any time to cease being a PIE by giving notice to the Commissioner. It will then cease being a PIE effective from 1 April after the election is made. However, once such an election has been made, the entity is prohibited from electing back into the regime within five years.

Qualifying criteria

In summary, to qualify as a PIE, an entity:

- must be established for the principal purpose of savings and investment by deriving certain types of investment income;
- must have a minimum number of investors;
- must invest as a "portfolio" (non-controlling investor);
- must not issue separate classes of interest to investors; and
- must be New Zealand resident for tax purposes.

Principal purpose of savings and investment

To meet the "purpose of savings and investment requirement", a PIE needs to

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use, or have available for use, 90% or more of its assets for deriving income from the owning or trading of the following: land; debt; shares; futures contracts; currency swap contracts; interest rate swap contracts; forward exchange contracts; forward interest rate contracts; options over any of the items above.

Minimum number of investors

A PIE must have at least 20 investors (with associated persons treated as one person) in each portfolio investor class. A portfolio investor class is a group of investors where each investor has an entitlement to a distribution of the proceeds of PIE assets that is the same as for the other investors in the group. The 20 investors requirement does not need to be satisfied if the only investors are PIEs or “foreign investment vehicles”. A foreign investment vehicle is an entity that meets the requirements for a PIE, other than the New Zealand residence requirement.

No investor is allowed to hold more than a 10% ownership interest in the PIE (or 20% for a New Zealand resident qualifying trust, a group investment fund, a New Zealand resident life insurer, or a superannuation fund). The 10% and 20% thresholds do not apply if the investor is itself a PIE or a foreign investment vehicle. Again, associates’ interests are aggregated.

Types of investment

A PIE must not hold an investment of more than 10% in a company (not being another PIE or a foreign investment entity) unless its investors have the right to redeem their interests at net asset backing at least every five years.

If the PIE has a greater than 25% investment in a company, not being another PIE or a foreign investment vehicle, then that investment must:

- not exceed 10 % of the total value of the

PIE’s assets; and

- the total amount of the portfolio investor class investment values (the proportion of the market value of the investments held by each portfolio investor class (the tax rate of each investor will determine the class to which they belong)) for such investments must not exceed 10% of the total value of all portfolio class investment values for all the portfolio entity investments in which investors in the portfolio investor class has interests.

Direct investments in land are not subject to these rules.

No separate classes of interest

A PIE may not issue different classes of units that stream different categories of income from the same asset to different interest holders. An example would be if the dividend stream from New Zealand equities went to low-tax rate investors and tax-free capital gains went to high-rate investors.

New Zealand tax resident

A PIE must be a New Zealand tax resident at all times. The PIE will not qualify as a New Zealand tax resident if it is treated under a double tax agreement as not being resident in New Zealand.

Effect of not meeting requirements

An entity is not eligible to be a PIE if:

- it fails to meet one of the qualifying criteria on the last day of a quarter beginning 6 months or more after the date on which the company becomes a PIE and ending more than 3 months before an announcement by the company to its shareholders that the company is winding up within 6 months of the announcement; and
- the failure to meet the requirements is repeated on the last day of the next quarter or is due to factors within the company’s control.



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An entity that ceases to be a PIE is treated for tax purposes as having disposed of and then reacquired the property of the entity, for market value. An entity that has ceased to be a PIE because it failed to meet the qualifying criteria cannot re-enter the PIE regime at any time in the future.

Tax free gains

Broadly, PIEs will not be taxable on realised gains on domestic shares (investments in New Zealand resident companies whether listed or unlisted) and shares in Australian resident companies that are listed on the ASX, provided that:

- The share must not be a non-participating redeemable share;
- There must be no dividend declared before the sale of the share that is paid after the sale;
- The entity must not be assured of a gain on disposal of the share under an arrangement with another person; and
- Within 30 days after the disposal there must not be a declaration of a dividend followed by a purchase of a share by the entity that confers the same rights and imposes the same obligations as the share that was disposed of.

Income from offshore shares held outside Australia will be calculated under one of the methods under the new foreign investment fund rules. The definition of “taxable income” will otherwise remain the same as it is under the Income Tax Act 2004.

PIE tax payments

A PIE will be required to pay tax on investment income based on the elected tax rate of its investors. Tax will need to be paid on investment income on a quarterly basis (although there is an ability to pay more frequently if desired), with tax being payable based on the tax rates of all people who were investors at any time during the relevant income calculation period.

PIEs will be required to remit tax payments to Inland Revenue quarterly, together with an accompanying return in a prescribed electronic format. These quarterly payments and returns will be due by the end of the month following the end of a quarter.

In addition, an annual reconciliation statement will need to be filed, in a prescribed electronic format, by 20 May of the calendar year in which the tax year ends.

PIEs will not be subject to the provisional tax rules.

Elected tax rate

The tax rate to be elected by an investor in a PIE will depend on the investor’s income level and on whether the investor is a resident entity investor as opposed to an individual.

Where the investor is an entity, such as a New Zealand resident company, New Zealand unit trust, or derives income as a trustee, the tax rate will be 0% and tax will not be paid by the PIE. The entity will then be responsible for payment of the tax on the income. Individuals will be able to elect a 19.5% tax rate if their total income from all sources (including PIEs) in the previous year does not exceed \$48,000. All other individuals will be subject to tax at 33%. This will generally be a final tax. A PIE is not responsible if an individual elects the wrong rate. An individual could be subject to penalties for knowingly electing the wrong rate.

Effect of tax credit received by PIE

Where the PIE receives a tax credit (for example an imputation credit or credit for tax paid or withheld), how the investors receive the benefit of the credit will depend on the investor’s tax rate.

If the investor is a New Zealand resident entity, it will be treated as receiving a proportional credit. For individual investors

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(subject to tax at 19.5% or 33%) the credit that reflects the investor’s proportionate interest in the entity reduces the PIE’s tax liability in respect of that investor. To the extent that the credit is not fully utilised it is treated as a rebate of tax for the investor. The rebate is limited to the lesser of the amount of the credit and the total tax paid to the Commissioner in respect of the particular investor (includes provisional tax, tax deductions and resident withholding tax). It is not yet clear as to the process by which the investor will claim or receive the rebate.

Effect of tax paid on individual investors

The entity must adjust the portfolio investor interest of each investor on a quarterly basis (or more frequently if it has elected to pay tax at greater than quarterly intervals) to reflect the effect of the individual investor’s tax rate on the amount of PIE tax paid by the entity. Any distribution paid by a PIE (made up of income that has been subject to tax under the PIE rules) will be excluded income of its investors. Because the distribution is not taxed, a PIE will not be able to be an imputation credit account company.

The tax paid by a PIE based on investors’ tax rates will generally be a final tax for individual investors. This means that individual investors will generally not be required to return this income in their tax returns and receiving PIE income is not likely to trigger a requirement to file a return where that requirement did not already exist.

Treatment of losses

Where a PIE has a loss for a portfolio entity period and the investor is a New Zealand resident entity, the investor is treated as having a deduction equal to their proportionate share of the loss. Individual investors subject to tax at 19.5% or 33% are

treated as having a rebate entitlement based on their proportionate share of the loss multiplied by their tax rate.

Land losses

Losses from a PIE’s direct investment in land are ring-fenced when the total value of land owned by a PIE exceeds 10% of the total value of the entity’s assets. If there is a land loss, it is added to a carry-forward amount (“portfolio investor class available land loss”). If there is land income, the loss carry-forward is reduced by the amount of the income.

Defined benefit superannuation schemes

Defined benefit schemes (as defined in the Income Tax Act 2004) that satisfy the PIE requirements will be able to elect to be PIEs. These entities will benefit from the exclusion for gains on sale of certain New Zealand and Australian shares but will pay tax at 33% on their income rather than based on investors’ tax rates.

Transitional rules

On becoming a PIE, a collective investment vehicle will need to undertake a “notional windup” (a deemed disposal and reacquisition of the vehicle’s underlying assets) under which any underlying assets held on revenue account will be brought to tax and any net income spread forward over three years.

If a loss arises on the “notional windup”, it will be ring-fenced at the PIE level. Any loss that cannot be offset against net income of a PIE will give rise to a formation loss carry forward amount. Any losses that relate to the period before a collective investment vehicle elected to be a PIE will also be carried forward into the new rules but ring-fenced against PIE income.

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