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Portfolio Investment Entities (PIEs)

The PIE regime was passed into legislation just before Christmas last year, and was subject to amendment throughout its passage through Parliament. Although the PIE rules only come into effect in October this year, there is already a large amount of activity in the funds management industry as people gear up to become PIEs.

The Policy Advice Division of Inland Revenue has released a five page note on its website listing a number of technical amendments to 'fix' the PIE rules. There is no draft legislation available yet for the amendments announced by Inland Revenue and it is testament to the pace at which things are moving that Inland Revenue decided to effectively announce changes to the law by proclamation rather than through releasing a draft bill.

So what is a PIE, and why is everyone getting so excited about them?

PIEs

PIE is short for portfolio investment entity. This isn't a new legal entity, but rather a company, superannuation fund or group investment fund that meets certain criteria and elects to be subject to the PIE rules. (Much like a company can elect to be subject to the LAQC rules).

These entities are separated into three groups, and each group has slightly different criteria that must be satisfied in order for the entity to elect to be subject to the PIE rules.

The three groups are:

- A "portfolio listed company" - which is a company listed on a recognised New Zealand exchange;
- A "portfolio defined benefit fund" - being a defined benefit superannuation fund;
- A "portfolio tax rate entity" - being a company, superannuation fund or group investment fund that does not fall into the two classes above. It is this class that will form the vast majority of PIEs.

We will discuss the eligibility requirements further, but before doing so, it's useful to first discuss why a company, superannuation fund, or group investment fund might want to elect to become a PIE.

Why elect to be a PIE?

The primary benefits from the PIE regime are:

- There is no tax on profits made by a PIE in trading in shares;
- The PIE pays tax on behalf of individual resident investors at the investor's

marginal tax rate, capped at 33%. Those investors do not have to file separate tax returns;

- Where an investor is a “zero rated” investor, the PIE is a flow through vehicle; this has particular advantages for non-taxable investors (such as charities).

Profits from trading in shares

The exemption from tax on the disposal of shares by a PIEs is limited to shares:

(a) in New Zealand companies; or

(b) in Australian resident companies that are both traded on an approved index under the ASX market rules and required under Australian tax legislation to maintain a franking account.

(The exemption does not apply to non-participating redeemable shares, irrespective of the location of the company in question.)

Shares in companies not covered by (a) or (b) will be subject to the new FIF rules (including the 5% fair dividend rate method) discussed in our previous *Update*.

Paying tax on behalf of investors

The tax payable by a PIE is calculated by reference to the marginal tax rates of its investors. So, for an individual investor on a 19.5% tax rate, the PIE would pay tax at 19.5% on its net income to the extent it is allocated to that particular investor.

There is no further tax to pay when the PIE distributes that income to the investor, and the investor is not required to declare that PIE income by filing a return. (This is quite useful for investors who are not otherwise required to file a tax return). This outcome can be compared with the existing company tax treatment where the company would pay tax at 33% on its net income, then distribute that income with imputation credits to its

shareholder, who is then taxed on that income but given credit for the attached imputation credits.

While the PIE rules provide a benefit for investors, calculating exactly how much tax is payable by the PIE is not easy. The PIE’s tax is determined by reference to “calculation periods” and “allocation periods”. The allocation period determines when the income of the entity is allocated to its individual investors for tax purposes. The calculation period is the time between each calculation by the entity of income and outgoings allocated in each allocation period.

At the end of each allocation period, the PIE must perform a set of calculations designed to ensure that tax is paid on income at the marginal rate of the investor concerned.

Flow through treatment

Non-individual resident investors are generally classed as “zero rated” investors. This means that the PIE does not pay any tax on that investor’s share of the PIE income. Instead, the investor is liable for tax itself when it receives a distribution from the PIE. The tax liability is determined by reference to the investor’s marginal tax rate. This means that investors who pay no tax (for example charities and local councils) are not taxed on the income they receive from the PIE’s activities.

Criteria to elect to be subject to the PIE rules

So, what tests do you need to satisfy to be a PIE?

Some of the eligibility requirements are applicable to all three classes and these are:

- *Form and business requirement* – the entity must be a company, superannuation fund or group investment fund (not in the business of life insurance);
- *Residence requirement* – the entity must

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be resident in New Zealand for the purposes of New Zealand's double tax agreements;

- *History requirement* – once an entity has opted out of the PIE regime, it cannot elect to re-enter within five years.

Other tests, although broadly applicable to all three classes, have slightly different requirements depending on the type of PIE in question. These are:

(a) *The investor membership requirement.*

The basic test is that there must be 20 or more unassociated persons investing in the PIE. However, this test can also be satisfied where there are less than 20 investors but at least one of the investors is listed in the PIE rules (for example, ACC). For a listed company, the membership requirement is satisfied if the company has only one class of shareholder and all of its shares are listed.

(b) *Investor interest size requirement.*

The basic test is that no one investor holds more than 20% of the PIE. In certain circumstances this threshold can be pushed out to 40% or, where the investor is listed in the PIE rules, 100%.

(c) *Further eligibility requirements relating to investments.*

There are a number of tests relating to the type of investment that the entity must enter into, the type of income it derives and ownership thresholds for the entity itself as an investor in other entities. The basic test is that:

- 90% of the entity's investments must be in land, debt or equity instruments that are "financial arrangements" or "excepted financial arrangements" (as defined in the tax legislation) or a right or option concerning one of these things;
- 90% of the entity's income must be derived from dividends, interest, rent, FIF income or sale proceeds from the investments (outlined in the preceding point);

- the PIE cannot hold 20% or more of another entity (unless that entity is listed in the PIE rules) except where that shareholding makes up less than 10% of the total value of the PIE's investments.

The above tests are the only requirements for a defined benefit superannuation fund to elect to be a PIE. The other two classes of entity have further requirements.

For a portfolio listed company (which is defined in the tax legislation to include certain group investment funds), the remaining tests are:

- *Imputation credit distribution requirement*
The company must have an imputation credit account and impute its dividends to the maximum extent possible; and
- *Income interest requirement*
The listed company cannot give investors rights to the proceeds from category B income (only relevant to group investment funds).

For a portfolio tax rate entity, the remaining tests are:

- *Investor return adjustment requirement*
The entity must make adjustments to reflect marginal tax rate changes of its investors within certain set timeframes; and
- Where the entity is a group investment fund, the *income interest requirement* (above).

* *This update only summarises complex rules and, as always, please seek professional advice if you intend to use the PIE regime. Please contact your Bell Gully tax advisor to discuss.*

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