Tax issues – a review of the tax treatment of investment income

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Outline

- Introduction
- Ambit of review
- Overview of current tax rules
- Problems with current tax rules
- Options for reform?
- Where to from here?

Introduction

- What the presentation is about
- Why has the issue become a Government priority?
- Stobo review – opportunity for consensus

Ambit of review

- On the table:
  - Investment in onshore equity through a managed fund
  - Investment in offshore equity directly
  - Investment in offshore equity through a managed fund

- Off the table:
  - Investment in onshore equity directly

Overview of current tax rules

- NZ investor purchases shares in NZ company
  - Taxed on dividends with imputation credit
  - Capital gain on sale generally not taxed
- Managed fund purchases shares in NZ company
  - Unit trust
    - Company tax treatment

Overview of current tax rules (contd)

- Managed fund purchases shares in NZ company (contd)
  - Superannuation scheme
    - Final tax at entity level (33%)
  - Life insurance
    - Two tier system
    - 33% tax at entity level

Overview of current tax rules (contd)

- Managed fund purchases shares in NZ company (contd)
  - Group investment funds (GIFs)
    - Category A income – company tax treatment
    - Category B income – trust tax treatment

Overview of current tax rules (contd)

- Direct investment in offshore portfolio equity
  - ‘Grey list’ rules
    - Benign
    - Generally only taxable on dividends
  - FIF rules
    - Harsh relative to grey list
    - Generally taxable on accrued capital gains

Overview of current tax rules (contd)

- Investment in offshore portfolio equity by managed fund
  - Same rules as for individuals investing offshore
  - Capital gains likely to be taxed for grey list investments

Problems with current tax rules

- Onshore equity investment
  - Tax rules favour direct investment
    - Economic harm as financial intermediaries have important role in economy
    - Unfair on lower and middle income savers

Problems with current tax rules (contd)

- Offshore equity investment
  - Grey list is main problem
    - Tax incentive to invest in high tax countries
    - Conduit entities in grey list countries (e.g. AUTs)
  - FIF rules far from ideal
    - May overtax
    - Liquidity
    - Risk
  - Foreign entity changes country of residence

Problems with current tax rules (cont)

- Marginal tax rate not the same as managed fund tax rate
  - Over-taxation
    - 19.5% savers in superannuation scheme
  - Under-taxation
    - 39% savers in superannuation scheme

Options for reform

- Onshore equity – direct versus indirect problem

  - 3 broad approaches
    - 1. Bring individual up to fund
    - 2. Bring fund down to individual
    - 3. Status quo

  - In current environment choice between 2 and 3

  - We prefer number 2

Options for reform (contd)

- Onshore equity – direct versus indirect problem (contd)
  - 2 broad options canvassed to achieve this
    - 1. Remove tax on capital gains of managed funds
    - 2. RFRM-type approach

Options for reform (contd)

- Offshore portfolio investment in equity
  - Grey list removed and FIF rules replaced
  - What should we replace FIF rules with?
    - Ideal – not achievable – need a reasonable proxy
    - RFRM – leading contender so far

Options for reform (contd)

- Addressing managed fund / marginal tax rate issue
  - Flow-through approach for managed funds
    - Managed funds no longer taxpayers
    - Taxable income attributed directly to investors
    - Managed funds withhold tax at correct marginal rates

Where to from here?

- Stobo report released later today
  - His ideas may not be same as ours in all areas
- Officials develop detail of proposal with stakeholders
- Proposal could be announced in 2005 Budget
  - Discussion document could be released around same time