Tax Working Group Information Release

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Meeting with Portfolio Investment Entity (KiwiSaver and other Managed Funds) Expert Advisors

Background Paper for Session 19
of the Tax Working Group

September 2018

Prepared by the Inland Revenue Department and the New Zealand Treasury

Meeting with Portfolio Investment Entity (KiwiSaver and other Managed Funds) Expert Advisors

1. The Group is meeting on 28 September with expert advisors to managed funds (including KiwiSaver) to discuss issues relating to extending the taxation of capital income (ETCI) to such funds. The purpose of this Paper is to provide some background for that meeting. Further background and discussion is at paragraphs 177 to 201 of the Appendix B to the Interim Report.

2. The people coming to meet with the Group are:

- John Cantin, tax partner KPMG;
- Darshana Elwela, tax partner KPMG;
- Greg Haddon, tax partner Deloitte;
- Matthew Hanley, tax partner EY;
- Tom Reiher, Chief Operating Officer MMC Ltd (an outsourced managed funds administration and registry service);
- Mark Russell, tax partner PwC.

Background on managed funds taxation

3. Investment income of most managed funds is taxed under the Portfolio Investment Entity (PIE) tax regime. The PIE regime came into effect in 2007 to provide a tax regime that would support KiwiSaver and generally be used by the managed funds industry. The PIE regime is intended to ensure that investors in managed funds do not have worse tax outcomes than they would have had if they invested directly. To ensure this, people who invest in PIEs are:

- Taxed on fund income at a rate that does not exceed their personal tax rate;[1] and
- Not taxed on gains from trading in New Zealand and Australian shares.[2]

4. There are a number of sub-regimes within the PIE regime to reflect the practicalities of taxing different types of collective investment vehicles. The most commonly used is "multi-rate PIEs" (MRPIE). This is the regime used by most KiwiSaver funds. In this regime:

- Taxable income earned by the fund is attributed to fund investors on a daily basis;

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[1] For other reasons the maximum PIE tax rate has been set at the company tax rate rather than 33%. This Group is recommending that the five percentage point discount be extended to the lower PIE tax rates applying to KiwiSaver funds.

[2] Consistent with the taxed-taxed exempt (TTE) principle of taxation of savings, the eventual payments from the managed fund (which represent the savings that the individual has put into the managed fund, and the investment earnings of the fund) to the individual investor are exempt from tax. This means the benefit of the non-taxation of New Zealand and Australian shares is not clawed back when the fund makes a distribution or redemption payment to the investor.

- Funds pay tax to Inland Revenue for each investor based on the investor's own tax rate;
- The tax is usually paid annually, except when an investor redeems units (leaves the fund), in which case the tax is calculated up to that point and paid shortly thereafter; and
- To ensure that each investor bears their own tax liability, the fund recovers the cost of the tax by cancelling units (taking the value of the tax from the investor's capital) for each investor's calculated tax on an annual basis. This means, for example, that even if Investor A and Investor B have the same interest in a fund during a year, if Investor B has a higher tax rate than Investor A, more of Investor B's units will be cancelled to pay tax than Investor A's.

Issues with taxing realised share gains

5. The current PIE tax regime fits the principle well that the tax resulting from investing in a managed fund should be similar to the tax liability arising if the investor made the investment and paid the tax directly.[3]

6. In the case of investing in shares, the outcomes are currently similar, with the investors deriving dividend income from New Zealand and Australian shares, and deemed income on foreign shares, at the same time and same amounts regardless of whether they invest directly or through a managed fund.

7. If we were to move to a regime where we tax the gains from the sale of Australian and New Zealand shares when realised, the tax outcome for investors could be different depending on whether they invested directly or through a managed fund. This is because of the redemption of units.

8. While in substance the amount and timing of income from selling the underlying shares (by the fund or the investor) would be the same, the investor could have a different tax outcome by redeeming units in the fund. Redeeming units would provide the same benefit to the investor as if they sold the underlying shares, but the fund will not have derived taxable income with respect to gains on those shares.

9. For example, suppose:

   - Fund has domestic shares worth $100;
   - Investor A buys units in fund for $100;
   - Shares increase in value to $150 (they are not sold by the fund);
   - Investor A redeems its units in the fund for $150[4];
   - Investor A has borne no tax with respect to the gain, even though it has sold its interest in them through redeeming the fund units;

[3] Although the tax outcomes are not identical. The tax rate from investment in a managed fund may be lower than if the investor invested directly if the investor is on a 30% or 33% tax rate. Sometimes a direct investor gets a better outcome for the tax on foreign shares due to a difference in how the fair dividend rate (FDR) rules apply.

[4] The redemption price might be reduced to take account of the tax liability on the appreciation, but this does not change the fact that no tax is paid by Investor A on the redemption.

- Investor B buys units in fund for $150;
- The shares fall in value to $140 and Fund sells its shares for $140. Fund attributes $40 of gain to investor B. The fund pays the tax (say $12) on behalf of investor B and takes units (capital) from investor B for the amount of the tax. Investor B now has units worth $128;
- Investor B redeems the units for $128.

10. The outcome of this is:
    - Investor A earns $50 and pays no tax; and
    - Investor B pays tax of $12 even though it has a $10 loss.

11. Investor A in substance sold its interest in the underlying shares (which would have been taxable if it did so directly) by redeeming its units in the fund.

12. Possible ways to address this include:

    - Making adjustments for investors entering and leaving the fund so they are taxed only on the proportion of the gains (and losses) that were accrued when they were investors in the fund. In the above example, this would involve taxing Investor A on $50 of income, and giving Investor B a $10 loss;
    - Taxing gains (and deducting losses) on the change in value of New Zealand and Australian shares on a daily basis (the rate could be discounted to approximate the difference in effective tax rates between taxing on accrual and realisation);
    - Taxing investors on the change in unit price (the value of their investment in the fund) instead of the underlying taxable income of the fund (again, the rate could be discounted to reflect the higher effective tax rate from accrual taxation); or
    - Taxing income on New Zealand and Australian shares on a deemed return, as is done for foreign shares under the FDR regime.

13. The PIE experts could discuss these approaches, as well as others they may raise or others that the Group may raise with them.

Level of tax on KiwiSaver

14. Some in the Group have also raised concerns about the level of tax imposed on KiwiSaver members from taxing realised gains on Australian and New Zealand shares. The Group is recommending changes to KiwiSaver that are expected to reduce the tax paid by members earning less than $48,000 by $215 million per year from 2021/22. We have estimated the increased tax for these members from taxing the gain on the sale of domestic shares to be significantly less than this.[5]

15. If there were to be a tax preference for KiwiSaver investing in domestic shares, this could distort the allocation of investment and whether certain investments are held directly or through KiwiSaver. This may be something the PIE experts could comment on.

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[5] Interim report p.52.