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Coversheet: Managed funds and retirement savings

Position Paper for Session 21 of the Tax Working Group
26 October, 2018

Purpose of discussion

The Group has asked the Secretariat to advise on how a more comprehensive tax on capital gains would apply to the managed fund industry, particularly KiwiSaver and other portfolio investment entities (PIEs). The purpose of this Secretariat paper is to put the Group in a position to make decisions on these issues. It also looks at the recommendations the Group has previously made regarding retirement savings through KiwiSaver schemes and considers the taxation of more capital gains as a 'package' with those other items.

Key points for discussion

- A more comprehensive tax on capital gains creates particular issues for KiwiSaver and the managed fund industry more generally. This is because the industry generally uses the PIE regime, which is a quasi flow-through tax regime and taxing gains on a realisation basis creates challenges in ensuring that income is attributed to, and tax is borne by, the appropriate members of the fund.

- The main issue with extending the taxation of capital gains to managed funds is how to tax New Zealand shares and Australian listed shares (Australian shares) and real property. This is because capital gains on Australasian shares and real property are currently untaxed. Capital gains on the other kinds of assets held by managed funds by contrast are currently taxed (although a more comprehensive tax on capital gains does raise the issue of whether the fair dividend rate (FDR) method should be retained).

- The method of calculating tax on capital gains for KiwiSaver and other PIEs should meet the following objectives. It should be:

    - workable (given the complex calculations required by PIEs) without requiring significant additional systems investment;

    - fair, both for entering and exiting investors and in terms of vertical and horizontal equity;

    - efficient, in that it does not distort investment decisions or adversely affect New Zealand's capital markets;

    - produce a broadly equivalent tax result for investors as if they invested directly, including imposing only one level of tax, unless unavoidable;
    - keep tax "outside the fund", so that the tax attributable to each investor is economically borne by that investor, rather than all investors as a fund expense;
    - not require regular tax filing by investors.

- The best design option may require trade-offs between these objectives.

Recommended actions

We recommend that you:

a **Agree** to tax the following types of managed funds on an accrual basis in respect of their Australasian shares:

- KiwiSaver funds and other multi-rate PIEs (MRPIEs) that do not own property;
- listed PIEs that do not own property;
- superannuation funds, subject to a de minimis exemption for small funds that could account for tax on a realisation basis;
- life insurance funds with a policy holder base.

b **Consider** whether a discount to the income arising under this method should be provided, to recognise the timing disadvantage of funds accounting for tax on an accrual basis, compared with direct investors accounting for tax on a realisation basis.

c **Agree** that, in respect of non-Australasian shares, the following options are viable:

- tax managed funds on an accrual basis and direct investors on a realisation basis (instead of FDR);
- tax both managed funds and direct investors under FDR; and
- tax managed funds on an accrual basis and direct investors under FDR.

d **Agree** that the Government should consult on these options more widely following publication of the Group's final report, with a view to determining the best method for both the managed fund industry and for direct investors.

e **Note** that currently listed Australian shares have the same tax treatment (tax on dividends only) as New Zealand shares, rather than like foreign shares (FDR). This issue will be addressed further in a subsequent paper.

f **Agree** that property PIEs be taxed under the following methods:

- For listed property PIEs, realisation based taxation of both the property PIE and the direct investor (as with an ordinary company). Income untaxed at the PIE level should be payable to any direct investors without further tax on receipt. However such income should reduce the cost base of the investor's interests in the PIE.

- For direct investors in property MRPIEs, taxation like a partnership, with an option to apply the same method as a listed property PIE in case this is not workable. This method involves the PIE calculating any tax payable on a sale of its property or the sale by an investor of its units in the PIE, and attributing that gain to the relevant investors.

- Managed funds would be taxed on their investment in a property PIE on a full accrual basis. Any income attributed to them by a property MRPIE would be ignored. They would not undertake any cost basis adjustments to their interests in a listed PIE (or a MRPIE electing the same option as a listed PIE).

g **Agree** to include the text in Appendix C in the Group's final report.

Managed funds and retirement savings

Position Paper for Session 21
of the Tax Working Group

October 2018

Prepared by Inland Revenue and the Treasury

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Executive Summary

Managed funds provide several benefits compared to investing directly, such as diversification (particularly for the less wealthy), ease of investment, and the expertise of the manager. Accordingly it is important that a more comprehensive tax on capital gains does not discourage investment in managed funds compared with direct investment.

Further, a more comprehensive tax on capital gains should also be consistent with the current portfolio investment entity (PIE) regime for KiwiSaver funds. In particular, it should not affect, if possible:

- the imposition of only one level of tax;
- the imposition of tax at portfolio investor rates;
- the calculation of tax on the same basis as if an individual invested directly;
- the PIE's ability to effectively pass on to an investor the tax it pays on behalf of that investor.

There are different kinds of managed funds, with different tax treatments. This paper has broken the managed fund industry down into the following categories for analysis:

- KiwiSaver funds and other multi-rate PIEs (MRPIEs) that do not own property;
- listed PIEs that do not own property;
- property-owning PIEs;
- superannuation funds; and
- life insurance funds.

There are numerous options for applying a more comprehensive tax on capital gains to each type of fund. In addition to the above considerations, we have assessed these options in terms of their workability, fairness, efficiency, and compliance obligations.

The main issues raised by taxing more capital gains for funds is how to tax New Zealand shares, Australian listed shares (collectively referred to as "Australasian shares") and real property. This is because capital gains on these assets are currently untaxed. Capital gains on the other kinds of assets held by managed funds are in effect taxed currently, and so these assets would not be directly affected by the extended taxation of capital gains (although more comprehensive taxation of capital gains does raise the issue of whether the fair dividend rate method (FDR) should be retained for other foreign shares).

For KiwiSaver and MRPIE funds, there are 3 viable options for taxing Australasian shares:

- Tax the fund's gains on its Australasian shares on an accrual basis (possibly with a discount). The fund's other shares would continue to be subject to taxation under the FDR method.

- Tax the fund's gains on its Australasian shares on a FDR basis.

- Tax all of the fund's shares on an accrual basis (including foreign shares currently taxed on a FDR basis).

Under all these options, no tax would be payable on any distributions from a PIE or on any sale or redemption of an investor's interest in a PIE.

The Secretariat recommends the taxation of Australasian shares on an accrual basis. This would be workable. The assets held by the funds are liquid and regularly valued. Therefore the main problems with accrual based capital gains do not arise for these assets.

For non-Australasian shares, there are 3 options:

- **Tax funds and direct investors under FDR (as currently)**. This would align the taxation of managed funds with direct investors, and would involve the least change to the current tax system.

- **Tax funds on an accrual basis and direct investors on a realisation basis**. This broadly aligns the taxation of both direct vs indirect investment, and Australasian vs non-Australasian shares.

- **Tax funds on an accrual basis and direct investors under FDR**. This taxes managed funds the same way on all their share investments. However it does create a different tax treatment for direct vs indirect investment in foreign shares.

The Secretariat considers that all these options are viable. The Secretariat recommends that wider consultation of these options is undertaken by the Government with the managed fund sector and the public, following publication of the Group's final report, in order to establish which method would be best for New Zealand. This consultation could include the question of whether Australian listed shares should still be excluded from the FDR regime. The Secretariat will advise the Group further on this issue in a subsequent paper for session 22.

Accrual taxation of funds does create a disadvantage compared with direct investment. This is because direct investors would be taxed on a realisation basis, and so would pay the tax on their gains later than funds would on an accrual basis. To remove this disadvantage, it might be desirable to tax the funds' accrued gains on a discounted

basis. On the other hand, the other tax benefits of PIEs might be sufficient to counter-balance this disadvantage, meaning no discount is necessary.

It would be desirable to tax all the different kinds of managed funds the same way as KiwiSaver and MRPIE funds, if possible. This would increase horizontal equity and fairness (by taxing the same kinds of income the same way), and prevent any tax related distortions in an investor's choice of investment vehicle. It would also be easier for investors to understand the funds' tax treatment if it was consistent.

Accordingly, the Secretariat recommends life insurance funds, share owning listed PIEs, and superannuation funds all be taxed the same way as KiwiSaver and MRPIE funds. However superannuation funds below a certain size should have the option of accounting for tax on a realisation basis.

It is not feasible to tax property owning PIEs on an accrual basis. This is because property is an illiquid asset, so the property PIEs may not have the cash flow to pay the tax on their accrued gains and there is less certainty in estimating the amount of accrued gains. Accordingly, the Secretariat recommends that:

- Listed property PIEs be taxed as ordinary companies. That is, with tax at capital gains at both the PIE level and the investor level, with some modifications to allow the PIE to distribute tax sheltered income without additional tax in the shareholders' hands on receipt (the tax sheltered income would reduce their cost bases instead). This would address the sector's main concern with a more comprehensive tax on capital gains and protect the tax base in the long term. However the requirement for investors to undertake regular cost-basis adjustments carries some compliance risks.

- Property MRPIEs be taxed in a similar manner to partnerships, with the PIE paying all the tax on any gains made by it or its investors. However property MRPIEs should also have the option to pay tax like a listed property PIE, in case this option is not feasible for some of them.

We include a table at the end of the report setting out the options for each type of fund, together with their current tax treatment and the Secretariat's recommendations.

1. Introduction

1.1 Purpose

1. The Terms of Reference direct the Group to consider whether taxing capital gains would improve the tax system. As part of this, the Group needs to consider how a more comprehensive tax on capital gains would apply to the managed fund industry, particularly KiwiSaver and other PIEs. The Group has set out some broad principles to which any new rules for PIEs should adhere (so far as possible). However it has not yet made any decisions on how managed funds and their investors should be taxed on their capital income. The purpose of this Secretariat paper is to put the Group in a position to make these decisions. The paper also considers how the implications of extending the taxation of capital gains to retirement savings, specifically KiwiSaver, should be addressed, particularly in relation to low to middle income earners – taking into account recommendations already made by the Group in its interim report.

1.2 Content and scope

2. This paper:

   - explains the current tax regimes for KiwiSaver / PIEs and other managed funds, including superannuation and life insurance;
   - sets out the issues that arise from applying a more comprehensive tax on capital gains to these managed funds, particularly in relation to KiwiSaver and other PIEs;
   - outlines the main design choices for each type of fund, with an analysis of their workability, advantages and disadvantages.
   - sets out the recommendations of the Secretariat for each type of fund;
   - considers how the implications of extending the taxation of capital gains to retirement savings should be addressed; and
   - includes some proposed text for the final report in Appendix C.

3. This paper does not specifically consider the New Zealand Superannuation Fund, whose tax treatment under a more comprehensive tax on capital gains may depend on other considerations.

1.3 Overview of managed fund industry

4. A managed fund is an entity which typically invests in financial instruments, shares or land for a pool of unrelated investors. The fund has a manager, who chooses

which investments to buy or sell and manages the fund's activity (hence the term "managed fund"). Managed funds are passive investors, meaning they do not run an active business (other than property leasing) or hold a controlling interest in companies.

5. The managed funds considered by this paper are a type of savings vehicle. Investors provide money to the funds, which invest it on their collective behalf and provide them with the investment returns.

6. There are also costs to managed funds from the perspective of savers. Fund managers charge a fee usually based on a percentage of the value of investments held on behalf of savers, and this can be a large portion of the total return earned by the savers from investing in the fund.

7. Managed funds provide several benefits compared to investing directly, such as diversification (particularly for the less wealthy), ease of investment, and the expertise of the manager. In particular, the pooling of investment and its reallocation generates a broader range of investments than individuals would generally be able to undertake on their own, providing benefits both to investors and to the economy. The pooling of investment reduces the overall costs and risks for investors and encourages investment in a broader range of businesses (including some newer or riskier businesses). Institutional investors may also play an important role in the efficient functioning of financial markets because investors rely on them, to some degree, to evaluate the governance of firms.

8. Managed funds include KiwiSaver funds, through which New Zealanders can save for their retirement. KiwiSaver funds are similar to other managed funds in most respects. The main difference is that an investor cannot withdraw their investment from a KiwiSaver fund until the age of 65 (subject to limited exceptions for first home purchases, financial hardship etc). While their withdrawals are restricted, KiwiSaver members can freely transfer their KiwiSaver savings between providers.

9. Most managed funds in New Zealand (including KiwiSaver funds) are taxed under the PIE regime. However there are some types of managed fund that are not subject to the PIE regime or have further tax issues that need to be considered. These are life insurance funds and superannuation funds. Māori authorities can be considered a collective investment vehicle, in that they hold assets and/or invest on behalf of their membership. However members cannot invest or save through a Māori Authority. Consequently they are not covered in this paper. Instead, the tax treatment of Māori authorities will be discussed in a separate paper on Māori collectively-owned assets.

10. There is also a direct investment management industry in New Zealand. This involves advisors managing investment portfolios for individual direct investors (such as high wealth individuals), rather than pooling their funds with other investors. This paper does not discuss the tax treatment of the direct investment management industry. However it is worth bearing the direct investment management industry in mind in evaluating the design choices for managed funds,

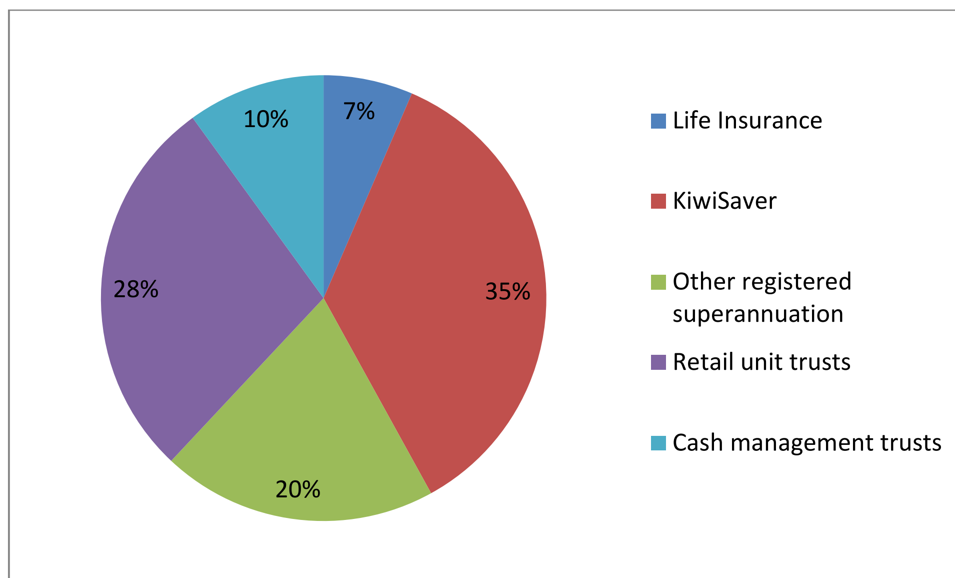
as the tax treatment of managed funds will affect the relative desirability and viability of the direct investment industry. It is important to note that direct investment provides some benefits for capital markets in comparison with managed funds. This is because a large group of direct investors provides more liquidity to the markets than the same number pooling their investment through a single managed fund.

11. Finally, the managed fund industry is split into retail and wholesale funds. Retail funds are open to investment by ordinary investors. Wholesale funds are open to investment only by other managed funds. A retail managed fund may invest directly in a particular asset, or it may invest into a wholesale fund that invests in that asset.

1.4 Size and composition of managed fund industry

12. The total consolidated assets of the New Zealand managed fund industry (ie. looking through the investment by one managed fund into another) were $132 billion in June 2018, and the total unconsolidated assets were $143 billion. The following diagram sets out the proportion of unconsolidated assets held by each type of fund (for which the Reserve Bank of New Zealand publishes data)[1]:

Figure 1 – Proportionate share of managed funds of sector



13. Investment in managed funds makes up 10% nearly of total New Zealand savings[2].

[1] All these figures are derived from the Reserve Bank of New Zealand Series T41 – Managed Fund Assets.

[2] Measured as a percentage of New Zealander's total net wealth under Reserve Bank of New Zealand Series C22 - Household Balance Sheet

1.5 Australian tax treatment

14. The New Zealand managed fund industry is in a different position from that in most other countries for tax purposes, due to our PIE regime. However we have considered the tax treatment of the Australian fund industry for the purpose of comparison in Appendix D.

1.6 Summary

15. This paper is summarised in Appendix C, in the form of the Secretariat's recommended wording for the final report.

2. Tax treatment of KiwiSaver and other PIEs

2.1 What are PIEs

16. A PIE (or portfolio investment entity) is a tax concept, rather than a legal entity. A PIE is a managed fund that elects into the PIE tax regime. A managed fund must meet several requirements to qualify as a PIE. These requirements are intended to ensure that a PIE is widely held (either directly or indirectly) and makes only passive investments in land, shares, or financial instruments. The PIE is generally prohibited from holding more than 20% of a company, which reflects its intended role as a passive investor. These restrictions are intended to confine the PIE regime to ordinary managed funds and prevent it being used for more active types of investment.

2.2 Purpose and tax treatment of PIEs

17. The PIE regime was introduced in 2007 to remove the tax disadvantages of investing through a managed fund compared to investing directly. A key impetus for the PIE regime was the introduction of KiwiSaver. If individuals were to be encouraged to save for retirement through managed funds via KiwiSaver, it was important that those managed funds were not taxed disadvantageously compared with direct investment.

18. The tax disadvantages of investing through managed funds at the time arose in two main ways:

    - A direct investor could hold their share investments on capital account, and so not pay tax on any gain made on sale. However a managed fund's share investments were usually held on revenue account, meaning the fund would be taxed on any gains made on sale. To remove this disadvantage, PIEs are not taxed on any gains made on selling New Zealand shares or listed Australian shares (with other foreign shares taxed generally under the fair dividend rate method for both PIEs and direct investors[3]).

    - A direct investor would pay tax on its investment income at its marginal rate. However a managed fund paid tax at a fixed rate (eg 33% for superannuation funds). This created a significant disadvantage for investors on a lower marginal rate. This was particularly an issue given that such investors stood the most to benefit from the investment diversification benefits offered by managed funds. To remove this disadvantage, income earned through a PIE is taxed at a rate which broadly corresponds to the investor's marginal rate (although the top rate is 28%, compared to a top personal rate of 33%).

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[3] Although individuals and family trusts have the option of returning tax on their actual gains from foreign share in an income year under the comparative value method. This provides a benefit to direct investors compared to managed funds in years where the foreign shares return less than the 5% FDR rate.

19. Extending the taxation of capital gains to New Zealand and Australian listed shares would remove the first of these disadvantages. However it would not remove the second. Accordingly there is still a good reason to retain the PIE regime following the introduction of a more comprehensive tax on capital gains.

20. Apart from the above, PIEs generally calculate their income under the ordinary rules. In particular:

    - Income from financial instruments is calculated under the financial arrangement rules, which tax interest and capital gains on a full accrual basis.

    - Income from foreign shares (other than listed Australian shares) is generally taxed under the FDR method. This results in annual income equal to 5% of the market value of the shares, with no tax on any gain from selling the shares.

    - Income from land is taxed under the ordinary tax rules – so rent is taxable and land may be (and generally is) held on capital account, depending on the circumstances.

2.3 Types of PIE

21. There are different types of PIEs, with varying tax treatments. These are tailored for the different types of managed funds. The main types of PIE are:

    - Multi-rate PIEs (MRPIEs), which includes KiwiSaver funds.

    - Listed PIEs (for funds listed on the stock exchange).

    - Property owning PIEs. These are either listed PIEs or MRPIEs. However they involve different considerations due to their investment in land rather than more liquid shares or financial instruments.

22. The specific tax treatment of each type of PIE is considered in more detail in the following chapters.

3. Criteria for analysis

3.1 General criteria

23. There are different options available for extending the taxation of capital gains to KiwiSaver and other managed funds. This paper assesses these options against the following criteria:

    - Workability: any solution should be workable without requiring significant systems investment by the funds.

    - Fairness: the option should be fair:

        - For entering and exiting investors - an entering investor should not become liable for tax on economic gains earned by the exiting investor.

        - In terms of horizontal equity – the option should produce a broadly equivalent tax result for investors as if they invested directly, and as compared with different types of income. In addition:

            - the option should keep tax "outside the fund", so that the tax attributable to each investor is economically borne by that investor at approximately its marginal rate, rather than shared by all investors at the fund's rate;

            - there should only be a single layer of tax on the income earned by the fund. So for example the fund and the investor should not both be taxed on the same underlying capital gain.

        - In terms of vertical equity – any benefits should targeted at less wealthy taxpayers.

    - Efficiency: the financial system is an important contributor to growth in New Zealand and has a role in allocating scarce capital to productive use. Accordingly any solution should not distort investment decisions between asset classes. Further, any option should promote a more balanced savings culture and deeper capital markets.

    - Investor compliance - the option should not require individual investors to regularly file tax returns.

24. These criteria incorporate the principles to which the Group decided any solution for MRPIEs should adhere. The best option may require trade-offs among these criteria.

3.2 Linkages to other tax issues

25. There is a linkage for the taxation of managed funds to other retirement savings proposals, particularly the decisions the Group has taken around low and mid-income savers. This paper includes a chapter discussing this issue.

26. There is also a linkage to the taxation of direct investors. Because one of the aims of the PIE regime is to broadly equalise the tax treatment of PIEs and direct investors, the Group may want to apply the same tax treatment for PIEs to direct investors.

4. KiwiSaver and other multi-rate PIEs

4.1 Investment profile

27. KiwiSaver funds invest in shares (nearly all listed) and financial instruments. Other MRPIEs also invest in these assets. KiwiSaver funds do not generally invest directly in land or unlisted shares (although they may invest in other funds that hold land). Some MRPIEs do invest in land, but the tax treatment of their capital gains is considered in a later chapter. This chapter only considers the tax treatment of MRPIEs that do not invest in land.

28. A more comprehensive tax on capital gains would only directly affect the taxation of Australasian listed shares for KiwiSaver funds and other non-property owning MRPIEs, as their other assets would continue to be taxed under the current rules (the financial arrangement rules for financial instruments, and the FDR method for other foreign shares).

KiwiSaver funds

29. There are 32 KiwiSaver fund providers. KiwiSaver had 2,889,894 total members on 31 August 2018[4]. The investment profile of KiwiSaver funds for June 2018 was as follows[5]:

Table 1: Investments by KiwiSaver funds - June 2018

Type of asset	Assets (in millions)
Total assets	**50,787**
New Zealand assets	26,361
Overseas assets	24,426
New Zealand assets	
Cash and deposits	4,139
Debt securities	6,058
Equities and units in trusts[6]	15,872
Other assets[7]	292
Overseas assets	
Cash and deposits	553
Debt securities	7,853
Equities and units in trusts[8]	15,963
Other assets[9]	57

4 See Inland Revenue's statistics at https://www.kiwisaver.govt.nz/statistics/monthly/schemes/

5 These figures are derived from the Reserve Bank of New Zealand Series T43 – KiwiSaver

6 This includes investment in other asset classes through New Zealand managed funds

7 These comprise: loans ($3 million); derivatives (-$45 million); other financial assets ($332 million); and non-financial assets ($2 million).

8 The data does not differentiate between Australian listed shares and other foreign shares.

9 These comprise derivatives ($44 million) and other financial assets ($13 million).

30. The Financial Markets Authority also provides detailed information about KiwiSaver funds, however its latest figures are for 31 March 2017. These figures are as follows[10]:

Table 2 – Investors and investments in KiwiSaver funds

Investment fund	Number of investors in each type of fund[11]	Amount invested in each fund (in millions)
Default (auto-enrolled)	446,534	4,584
Other general funds		
Default (chosen by saver)	284,691	3,499
Conservative	602,587	6,923
Balanced	643,688	10,936
Growth	943,453	11,863
Single sector funds		
Cash	289,620	1,616
Shares	48,197	432
Fixed interest	25,622	156
Property	5,401	41
Socially responsible	7,151	72
Other[12]	47,512	639
Totals	**2,897,922**	**40,762**[13]

31. From these figures, it can be seen that KiwiSaver funds invest significantly both in New Zealand and offshore. The asset classes into which they invest are financial instruments (both cash and debt securities), New Zealand equities and foreign equities. KiwiSaver funds do not invest directly into land (although they hold a small number of shares in property companies) or other tangible assets (they hold only $2 million in non-financial assets out of $50.8 billion). 25.2% of members were in a low-risk default fund (as at 31 March 2017).

Other MRPIEs

32. Other retail unit trusts[14] held the following assets in June 2018:

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[10] See Financial Markets Authority *KiwiSaver Annual Report 2017*, Appendix 6

[11] Some members invest in more than one fund, so the total for this column is higher than the total number of KiwiSaver members stated above.

[12] These are, in the main, life stage products that invest the member in the appropriate fund for their age range.

[13] The total is more than the sum of the above figures due to rounding

[14] These figures are derived from the Reserve Bank of New Zealand Series T45 – Retail unit trusts. We do not have any data that is specific to MRPIEs, however we expect that the great majority of the retail unit trusts reported on here are MRPIEs

Table 3: Investments by other retail unit trusts

Type of asset	Value (in millions)
Total assets	**40,113**
New Zealand assets	24,326
Overseas assets	15,787
New Zealand assets	
Cash and deposits	8,393
Debt securities	5,154
Equities and units in trusts[15]	10,725
Other assets[16]	54
Overseas assets	
Cash and deposits	614
Debt securities	3,675
Equities and units in trusts[17]	11,447
Other assets[18]	54

33. This shows a very similar investment profile to KiwiSaver funds. In particular, other retail unit trusts do not invest directly into land or other tangible assets (they hold only $108 million in non-financial assets out of $40.1 billion). However this data does not include PIEs that invest into property.

4.2 Tax treatment

34. MRPIEs are the most common type of PIEs. Nearly all KiwiSaver funds are MRPIEs. Only two smaller KiwiSaver funds are not a MRPIE (these are taxed as a widely held superannuation fund)[19].

35. MRPIEs have the following tax features:

- The PIE's income is calculated under the ordinary tax rules, with several exceptions. In particular, the PIE is not taxed on any gain from selling Australasian shares.

- The PIE allocates its income to its investors in proportion to their interest in the PIE. The PIE then pays tax on that income at a rate which is similar to the investor's marginal income tax rate (as discussed below). However the top PIE tax rate is 28%, which is 5 percentage points lower than the top 33% marginal tax rate for trusts and natural persons. The PIE pays tax at 0% on income allocated to some types of entity (including other PIEs). This allows a PIE to invest in another PIE with only a single layer of tax.

[15] This includes investment in other asset classes through New Zealand managed funds

[16] These comprise: derivatives ($5 million); other financial assets ($48 million); and non-financial assets ($1 million).

[17] The data does not differentiate between Australian listed shares and other foreign shares.

[18] These comprise derivatives ($26 million) and other financial assets ($26 million).

[19] We consider the application of a more comprehensive tax on capital gains to superannuation funds in chapter 8

- The economic cost of the tax paid by a PIE on income allocated to an investor must be passed on to that particular investor. The PIE does this by adjusting each individual investor's interest in the PIE (or its distributions from the PIE) to reflect the tax paid in respect of that particular investor. Accordingly, the tax paid by the PIE on an investor's income is economically borne by that particular investor only. In this way, the PIE effectively pays tax on behalf of each investor.

- If the PIE pays tax on income allocated to an investor, then the investor is not taxable on that income (subject to some minor exceptions which are not relevant here). Where the PIE does not pay tax on income allocated to an investor (ie. the investor is subject to the 0% rate), the investor is personally liable for the tax on that allocated income at its marginal rate. Such investors still receive the benefit of the tax exemption for gains on sale of Australasian shares.

- No tax is paid on any distributions by the PIE to its investors or redemptions of units in the PIE.

36. From this it can be seen that investment through a PIE is broadly taxed as if the investor held their share of the PIE's investments directly. However the PIE is responsible for remitting that tax for investors not on a 0% rate (such as natural persons), meaning they do not need to file tax returns.

PIE tax rates

37. The maximum PIE tax rate is 28%. When the PIE rules were put in place, an important consideration was New Zealand's lack of a capital gains tax. There were other entities where income could be taxed at the company tax rate and where this ended up as a final tax. This included investment in unit trusts. The same was arguably true for investment in companies when shareholders were able to sell their shares and generate tax free capital gains (that is the company would pay tax on its income at 28%, and the shareholder could then realise the benefit of that income by selling its shares tax free).

38. Rather than basing PIE tax rates on taxpayers' marginal tax rates in the year that income was earned, PIE investors were able to nominate tax rates from one of the prior two years. This was to allow as many PIE investors as possible to not have to file income tax returns, and to know their relevant income information with certainty. There was not the possibility that arises under Business Transformation for there to be automatic square-ups without taxpayers needing to file returns.

39. For investors on tax rates below the capped rate, there are also generous rules, as illustrated in the table below. These are aimed at ensuring there was no over taxation of those with income just below a tax threshold. This allowed investors to choose the PIE tax rate for them that was equivalent to their personal marginal tax rate based just on their taxable income (disregarding amounts earned in PIEs). In

order to limit the benefit of earning significant PIE income at a low tax rate, there is a separate threshold based on taxable plus PIE income. It means there will be numerous cases where an investor's taxable plus PIE income would put them in a higher marginal tax rate if they earned investment income directly instead of through the PIE.

Table 4 – PIE tax rates

Marginal tax rate	Individual tax rates – for the current year	PIE tax rates – For **either** of the two prior years:	
	Taxable income	Taxable income	Taxable + PIE
10.5%	<=$14,000	<=$14,000 AND	<=$48,000
17.5%	$14,001 - $48,000	<=$48,000 AND	<=$70,000
28%	NA	>$48,000 OR	>$70,000
30%	$48,001 - $70,000	NA	NA
33%	>$70,000	NA	NA

4.3 Interim decisions of the Group

40. In relation to MRPIEs, the Group has not yet decided how Australasian shares and real property should be taxed. However the Group's interim decision was that, so far as possible, any new rules would not disturb the following features the current rules:

- the imposition of only one level of tax;
- the imposition of tax at portfolio investor rates;
- income calculated on the same basis as it would be if an individual invested directly; and
- keeping tax "outside the fund".

4.4 Taxing the capital gains of MRPIEs and KiwiSaver funds

41. As noted above, MRPIEs and KiwiSaver funds derive their income from financial instruments, Australasian shares (nearly all listed) and foreign shares.

42. Financial instruments are currently subject to full accrual taxation on any capital gains, and this is not proposed to change. Foreign shares are currently subject to the fair dividend rate (FDR) method, and the Group's interim decision is for this to continue following the introduction of a more a comprehensive tax on capital gains (subject to a possible change in the rate). However gains on selling Australasian shares are currently exempt. Accordingly, the main issue for taxing the capital gains of KiwiSaver and other MRPIEs is how to tax gains on Australasian shares.

43. A key consideration here is the need to allocate capital gains and losses to investors not on a simple pro rata basis (that is, pro rata with the value of their investments on the day of realisation). Instead realised gains and losses need to be allocated taking into account the movement in the value of the assets during the period the investor has actually been invested in the MRPIE.

Example 1

An MRPIE buys an asset at the beginning of June for $1,000. At the beginning of July it is worth $1,300 and at the end of August when it is sold it is worth $1,200 (so the income to be allocated to investors is $200). Suppose also that investors A and B own 1% of the MRPIE at the beginning of June, but at the beginning of July, B redeems her units for $13, and is replaced by C, who invests an equivalent amount. A owns 1% of the fund throughout the period.

In order for the current benefits of the PIE regime to be retained, A and C cannot be allocated an equal share of the $200 gain on realisation of the asset at the end of August. A must be allocated $2, i.e. 1% of the gain. However C bought into the fund on 30 June, when the asset was worth $1,300. That is, C will have paid $13 for her 1% interest in the asset. It would clearly be wrong for her to be taxed, like A, on $2 of the realised gain. She should have a loss of $1. The balancing figure is B, who should have a taxable gain of $3, which will reflect her economic gain on exiting the MRPIE on the basis that the asset was worth $1,300.

44. Currently this kind of calculation is not required. All of a MRPIE's taxable income is able to be accrued on a daily basis (using either a market value method or the FDR method) and allocated to investors on a per unit basis during that day. Changes in the value of Australasian shares are accrued, generally on a daily basis, for the purpose of determining the prices at which the fund should issue and redeem units. But there is no need to allocate realised capital gains at all, because those gains are not taxed.

4.5 Options

45. There are 6 different options for taxing the capital gains on Australasian shares held by KiwiSaver funds and other MRPIEs:

- Option 1 - retain the status quo ie. exempt gains from selling Australasian shares.

- Option 2 – tax Australasian shares on a realisation basis and attribute gains to investors on a look-through basis (similar to a partnership).

- Option 3 – tax Australasian shares on an accrual basis (possibly with a discount).

- Option 3A – tax all shares on an accrual basis, including non-Australasian shares.

- Option 4 – apply FDR to all shares (including Australasian shares).

- Option 5 - tax KiwiSaver / PIE funds directly on realised gains with no attribution to investors. This means that PIE (including KiwiSaver) investors would bear tax on the gain at a rate that may be different from their PIE tax rate.

46. We consider that options 1, 2, and 5 are not desirable options for MRPIEs:

    - Option 1 would distort economic decision making by the PIE, benefit wealthier taxpayers the most, and is a poorly targeted incentive to save.

    - Option 2 is not feasible for MRPIEs to implement from a systems perspective.

    - Option 5 would remove the current flow through tax treatment of PIE income.

    We set out reasons for these conclusions further in Appendix A.

47. This leaves options 3, 3A, and 4 as possible solutions. Under all of these options, an investor would not be taxed on any distributions from a MRPIE, or on any gain on sale or redemption of its interests in the MRPIE. Further, the investor would not need to file a tax return, as the tax on its share of the MRPIE's income would be calculated and paid by the MRPIE.

48. We consider the workability, advantages and disadvantages of these options below.

Option 3 – tax Australasian shares on an accrual basis

49. Under this option, a MRPIE would pay tax on its Australasian shares on an accrual basis. This means it would be taxed on any gains as they accrue, rather than when the shares are sold.

50. This accrual basis would be the same as the current comparative value method in the Income Tax Act 2007 (which applies in respect of interests in foreign investment funds as an alternative to FDR). Under this method, an investor's income for a period (eg an income year) is calculated under the following formula:

    (closing value + gains) – (opening value + costs)

51. The terms in this formula mean the following:

- **closing value** is the market value of the person's Australasian shares at the end of period;

- **gains** is any dividends received on the Australasian shares (before any withholding taxes), plus any proceeds from selling Australasian shares, during the period;

- **opening value** is the market value of the person's Australasian shares at the beginning of the period;

- **costs** is the amount paid by the person to acquire Australasian shares during the period, plus any foreign tax paid by the person on the shares during the period.

Example 2

A person owns Australasian shares with a total value of $1,000 at the start of the income year and $2,000 at the finish. The person sells some shares for $200 during the year, and reinvests $100 of that in further Australasian shares. The person also receives a dividend of $50.

The person's income under the accrual method for the year would be calculated as follows:

> ($2000 closing value + $250 gains ($50 dividend + $200 sale proceeds)) – ($1,000 opening value + $100 costs) = $2250 – $1100 = $1150 income

Therefore the person would return $1150 of income in respect of their Australasian shares.

52. Essentially the accrual basis taxes a person on their total economic gain in respect of their Australasian shares during the year. It does this by measuring any accrued gain or loss in the value of the shares over the period, then adding or subtracting any cash receipts or costs incurred in respect of the shares.

53. In the fund context, this would involve the MRPIE calculating the gain or loss on its Australasian shares each day (assuming it valued its units daily), allocating that gain or loss to its investors, and paying the tax on that gain at the investor's PIE tax rate. Any losses would be rebated to the MRPIE in cash by the Government and passed on to the investors by the MRPIE (either by issuing additional units or distributing the rebate in cash).

54. Any gain or loss made by an investor in respect of its units in the MRPIE could be ignored under this approach, as the investor's share of the MRPIE's capital gains would already have been fully taxed at the MRPIE level. Accordingly redemptions, distributions, and sales of units in the MRPIE would all be ignored.

55. This treatment would also apply to any units one MRPIE held in another MRPIE. Since the first MRPIE's income would already be taxed on a full accrual basis, the second MRPIE should not additionally return any capital gains in respect of its interest in the first MRPIE. Therefore a MRPIE would not return any accrued gains on its interests in another MRPIE.

56. This outcome should be easy to achieve, as the existing MRPIE regime already provides for income to be flowed through chains of MRPIEs with only a single layer of tax at the ultimate investor's PIE tax rate. Accordingly, this option would accommodate investment by one MRPIE into another with minimal system change requirements.

57. This approach has several advantages. First, it is workable. As tax would be calculated on a MRPIE's capital income from Australasian shares as it accrued, there would be no need for detailed and complex record keeping systems. A further advantage is that the method for calculating the tax payable under this option is the same method MRPIEs currently use for calculating their net asset value. It should therefore impose relatively low systems costs for MRPIEs to implement. The funds we consulted with in preparing this paper all indicated that this option would be workable for them.

58. In addition, valuation and liquidity issues are the main reasons for not generally taxing capital gains on an accrual basis. Neither would seem to be a problem for these types of PIEs. Their assets are valued, usually on a daily basis, and are easily realisable.

59. This option would also apply to New Zealand unlisted shares. However we note that the entire managed fund industry only holds $500 million of unlisted shares, compared with a total asset pool of $132 billion in June 2018[20]. This means that taxing unlisted shares on an accrual basis should not create any liquidity issues. In addition, MPRIEs still need to value their unlisted shares periodically in order to accurately price their units. Consequently this option should also work in relation to the unlisted shares held by MPRIEs.

60. This approach would also meet most of the criteria for fairness, efficiency and investor compliance. In particular:

- It is fair for entering and exiting investors, as all the tax on any accrued gains is paid daily. This means investors are only subject to tax on gains made over the period when they held the units.

- It is mostly fair in terms of horizontal equity, as it:

    - results in a single layer of tax; and

[20] See the Reserve Bank of New Zealand series T41 – managed fund assets

- allows the tax to be economically passed on to the investor, but collected and returned by the PIE.

- It does not raise any serious vertical equity or efficiency concerns – although it would tax Australasian shares under a different method (accrual) to other foreign shares (FDR). How much of an issue this is depends on the Group's view of the equivalence between a risk-free tax basis and full-return tax basis from an economic perspective.

- It would not require investor to file income tax returns.

61. The main disadvantage of this approach is that it taxes capital gains from Australasian shares on an accrual basis, whereas direct investors would be taxed on the same gains on a realised basis.

Example 3

A PIE holds $1,000 of Australasian shares for 3 years and then sells them for a gain of $200. All the PIEs investors have a 28% PIE tax rate.

- In the first year, the shares appreciate by $250, so the PIE returns income of $250 for that year and pays tax of $70.
- In the second year the shares appreciate by $100, so the PIE returns another $100 of income and pays another $28 of tax.
- In the third year the shares depreciate by $150, so the PIE makes a loss of $150 for that year and claims a cash rebate of $42.

The PIE has paid a significant amount of tax in the first year, less in the second year, and is entitled to a cash rebate for its loss in the third year.

By contrast a direct investor would only calculate its income and pay tax in respect of the shares at end of year 3, when it sold them. Therefore a PIE has had to pay the tax on the gain on the investment earlier under the accrual method than the direct investor.

However if the direct investor had a marginal rate of 33%, then it would pay tax of $66 on its $200 gain. However if the person invested through the PIE, they would only be subject to tax of $56 on that same gain, due to the PIEs top 28% tax rate on its income.

62. Accordingly taxpayers investing through a PIE would suffer a timing and volatility disadvantage under this option compared to investing directly, as tax on their gains would be paid earlier (on accrual compared with on realisation).

63. This disadvantage could be mitigated or removed by discounting the amount of the PIE's taxable income from is accrued capital gains on Australasian shares. For example if the discount rate was set at 10%, then the PIE would only pay tax each year on 90% of its accrued gain for that year.

64. The amount of the discount required to make accrual and realisation based taxes equivalent depends on the MRPIE's level of turnover and on its nominal interest rate.

Example 4

Assuming a tax rate of 28%, a nominal interest rate of 5%, and a fund that realises 20% of its accumulated accrued capital gain each year (reflecting an average 5 year holding period), the appropriate rate of discount would be 12%. That is, for each $100 of accrued gain, $88 should be subject to tax.

At a 50% realisation rate (reflecting an average two year holding period) the appropriate discount rate would only be 3%, so that for each $100 of accrued gain, $97 would be subject to tax (a shorter holding period means taxing on accrual rather than realisation is less costly and therefore justifies a smaller discount).

65. Adoption of a single discount rate for all capital gains on Australasian shares would give a disproportionately large benefit to funds with high turnover, and a disproportionately small benefit to funds with low turnover. However, it would likely be complex to provide a discount that takes into account a fund's actual trading history, which is likely to change over time. It would also be more difficult for investors to understand. Therefore adoption of a single discount rate would be an appropriate simplification measure.

66. On the other hand, MRPIEs already enjoy tax benefits compared with direct investment, such as a lower top tax rate and easier tax compliance for their investors (particularly following the introduction of a more comprehensive tax on capital gains). In addition, an accrual based tax would remove the need for the loss ring-fencing that a realisation based direct investor would be subject to (as under an accrual system, an investor could not "cherry-pick" by selling shares with losses and deferring the sale of shares with gains). It could be argued that these existing benefits are sufficient to compensate for the timing disadvantage of accrual taxation when investing through a MRPIE. These existing differences also suggest it is not necessary for direct investors and indirect investors to be taxed completely alike.

67. This option would require the Government to pay cash rebates in respect of losses incurred by PIEs on Australasian shares. This could expose the Government to fiscal risk in the event of an Australasian share market crash (although the cashed out losses would also have a stimulating effect on the economy).

Option 3A - tax fund on all shares on an accrual basis, possibly with a discount

68. A variation of option 3 is to tax all of an MRPIE's shares on an accrual basis ie. including non-Australasian shares (which are currently taxed under FDR). If a discount were considered appropriate under option 3, then it would also apply to Australasian shares under this option[21].

[21] However the discount should not apply to non-Australasian shares if the de minimis exception for direct investors is removed. This is because direct investors would be taxed on these shares under FDR, rather than on a realisation basis. The de minimis exemption means that natural persons with foreign shares costing less than NZD$50,000 are not subject to taxation under FDR. Instead they can currently hold these shares on capital account.

69. This option would have the benefit of simplicity, in that funds would apply a single method to calculate taxable income from their share portfolios. This would also have efficiency benefits, as taxing Australasian and non-Australasian shares the same way would remove any possible tax distortion affecting a fund's investment choice. This approach would also address the current issues with taxing currency hedges held by funds in respect of FDR shares[22].

70. Further, FDR was introduced to address a problem with the under-taxation of foreign shares. This problem arose because of the absence of a capital gains tax[23]. If a more comprehensive tax on capital gains is introduced, then the FDR arguably is not needed.

71. On the other hand, this approach could result in a different tax treatment of funds compared with direct investors in non-Australasian shares (as the direct investors would remain subject to FDR). While the outcome overall may be similar from an economic perspective (if the FDR rate is set correctly), it could produce very different results for particular funds and taxpayers.

72. For example a growth fund that made a 13% return on its US shares in a particular year would be taxed on the full gain on an accrued basis, whereas a direct investor in the same assets would only be taxed on a 5% return. On the other hand if that same growth fund made a 13% loss the next year, it would receive a cash refund for the tax effect of that loss, whereas a direct investor would still have taxable income of 5% of the opening market value of the shares in that year[24].

73. It is not clear how investors would respond to this difference in tax treatment. More optimistic investors would likely prefer direct investment, more risk averse would prefer fund investment. Perhaps the more significant point is that the tax picture would be a confusing one, and might play a larger part in the marketing of savings products, and decisions about savings products, than desirable.

74. Accordingly this option can be thought of (in comparison to option 3) as trading off equal tax treatment of a fund's share investment against equal treatment of direct and indirect investors.

75. One way to address the difference in tax treatment between direct and indirect investors is to require direct investors to account for tax on a realisation basis in respect of their non-Australasian shareholders. This broadly aligns the taxation of both direct vs indirect investment, and Australasian vs non-Australasian shares. It

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[22] The issue is that any FX changes are fully taxed for the currency hedge under the financial arrangement rules, however they are not taxed for the foreign shares under the FDR rules. This means that fully hedged FDR shares result in taxable income or losses as FX rates change, even though there is not net gain or loss economically. This issue is sought to be solved by legislation, but the solution is complex and may not be adopted very widely.

[23] The problem was that many foreign companies paid dividends and low rates and relied on increases in the share price to create value for the shareholder. This allowed taxpayers to realis most of their income from their foreign shares in the form of untaxed capital gains on sale.

[24] Although currently individuals and family trust could elect to be taxed on their actual gains in that year under the CV method, and so would return no income in respect of the loss year and a 5% maximum income for the gain year.

also has the benefit of giving a good tax treatment for hedging for funds. On the downside it allows for deferral on foreign shares held by individuals and can give rise to some difficult technical issues around demergers and share splits. It would also involve cashing out all foreign share losses to the PIE.

Option 4 – apply FDR to Australasian shares

76. This approach would involve applying FDR to a fund's Australasian shares, along with its non-Australasian shares.

77. The resulting FDR income would then be attributed to the investors in the MRPIE, with tax paid on that income at their PIE tax rates by the MRPIE. As with the accrual option, the existing PIE regime would allow this income to be flowed through chains of MRPIEs with no tax, and then taxed at the positive PIE tax rate of the ultimate investor.

78. This approach would be workable and should not require significant systems changes (as MRPIEs are already required to apply the FDR method to their non-Australasian shares). The funds we consulted with in preparing this paper indicated that they could adopt this option without significant systems investment.

79. This option would also have the same advantages as option 3 in terms of fairness and efficiency. In particular:

    - It is fair for entering and exiting investors, as all the tax on any shares under the FDR method is attributed daily. This means investors are only subject to tax for gains made over the period when they held the units.

    - It:

        - results in a single layer of tax;
        - allows the tax to be economically passed on to the investor, but collected and returned by the PIE.

    - Does not raise any vertical equity or efficiency concerns, provided the FDR rate is set correctly.

80. This option has the same disadvantage as option 3A, in that it would tax direct and indirect investors more differently in respect of their Australasian shares than option 3. Accordingly this option would lack horizontal equity. Direct investors in Australasian shares would be taxed on their full return on a realised basis, while investors through a MRPIE would be taxed on those same Australasian shares under FDR. As noted above, taxation on a full return basis and taxation under FDR can result in quite different tax outcomes for individuals, depending on the circumstances.

81. There are also some important issues that would need to be considered in applying FDR on New Zealand shares in relation to imputation credits.

- If imputation credits were not creditable against the liability to pay tax on FDR income, then double tax would arise.

- Another option is to allow any imputation credits received from a company to offset the tax arising from the MRPIE's FDR income from its shares in that company, but not allow any excess imputation credits to be claimed by the MRPIE. However this tax result would still be very harsh for investors owning New Zealand companies through MRPIEs. This is because:

  - the MRPIE would be taxed on its share of the New Zealand company's income at the FDR rate; but

  - tax would also be payable on any return above at the FDR rate at the company level (as the company would pay tax on all its income, but the MRPIE would only claim imputation credits for that tax up to its 5% FDR income).

- This would result in FDR rate becoming a minimum tax, with full taxation of any return above that rate and no deduction for losses. Therefore over-taxation would result over time. This would be a significantly worse tax treatment than that applying to direct investors in New Zealand companies. Therefore we do not think it is feasible to limit the amount of imputation tax credits that an MRPIE can claim under the FDR method.

Example 5

A company makes a 12% return one year, which it pays tax on and distributes to the investor. Then in the next year, the company makes no return, and pays no distributions.

In theory, there are two options for taxing this:

- full return taxation (which taxes both the risk free and risk components of the return, with a deduction for any losses); and

- FDR taxation (which taxes a deemed risk free return each year and ignores any risk related gains or losses above or below the risk free rate).

If we tax the full return, then we should tax the company on 12% in the first year, and 0% in the second year (with no tax for the MRPIE due to the imputation credits). If we taxed at the FDR rate, then we should tax 5% in the first year and 5% in the second year. Therefore we should be taxing a total return of either 12% or 10% over the 2 years, depending on our method.

However if tax the funds under FDR and limit credits to their FDR income, then we would tax:

- a 12% actual return in the first year at the company level (with no tax at the

MRPIE level due to the availability of imputation credits up to, but not beyond, its 5% FDR income); and

- a 5% deemed return in the second year at the MRPIE level (with no tax at the company level due to a lack of income).

Therefore we would tax a total return of 17% over the 2 years.

Accordingly limiting imputation credits will result in over-taxation over time, as it will tax the full upside return over the 5% FDR rate, but will also tax any returns below 5% (including losses) at that 5% rate.

82. This means imputation credits in excess of the FDR return (on New Zealand shares held by a MRPIE) would need to be available for offset against the MRPIE's other income, and (under current settings) cashed out if there is insufficient other income. This would be coherent, in terms of the economic theory behind a risk free rate method (RFRM) such as FDR. However it would give rise to several practical and boundary issues:

    - It would effectively tax New Zealand's listed sector on a RFRM basis instead of under the current corporate tax system, at least in respect of its managed fund or New Zealand resident shareholding (if non-fund New Zealand residents were also offered the RFRM option). This would be a significant change to the current tax system, with consequences beyond the taxation of managed funds, or the more comprehensive taxation of capital gains. The Group would need to consider the wider consequences of this carefully. For example we have forecast that such a change would reduce the tax the Government collected from the listed sector. It would also raise the importance of being able to accurately set the FDR rate.

    - The FDR method could only be applied to listed shares, as RFRM methods only work where the total value of the company (including its growth potential) is fully reflected in market valuations. This would leave the question of how to tax managed funds on their investment into unlisted New Zealand shares. This issue is not currently significant, given the low level of investment into unlisted shares by the managed fund industry. However it may become more significant if it resulted in under-taxation of a managed fund's investment into unlisted shares, and so incentivised investment into unlisted shares through managed funds.

    - The approach would create boundary issues between listed and unlisted New Zealand companies, as the overall taxation of their income would be very different.

    - The tax treatment would result in quite a different tax outcome for investment in listed shares through a managed fund compared with currently. In most years, investors through managed funds would pay less

tax than direct investors (as reflected in our revenue forecasts below). In loss years the managed funds would pay more tax than direct investors.

83. Another issue with this approach is that it moves a fund's tax position further away from its accounting and unit valuation position. This is because the tax payable by a fund in respect of an investor will bear little relation to the gains or losses of that investor. For example investors whose units declined in value over the period will still be subject to the tax. This may be hard for some investors to understand.

84. This option could still be feasible however, depending on the Group's view of these issues.

4.5 Fiscal impact

85. The fiscal impact of all these options relative to current settings is set out below. We note that the fiscal impact has been calculated across the whole managed fund sector, as we recommend later in this paper that other collective investment vehicles (other than property owning PIEs) use the same approach as that adopted for MRPIEs.

86. There is uncertainty in these estimates and the assumptions used will drive the results. The Secretariat intends to undertake further quality assurance on these estimates and so they should be considered preliminary.

Table 5 – Fiscal estimates compared with current settings

($m)		***2021-22***	***2022-23***	***2023-24***	***2024-25***	***2025-26***
Option 3 - taxing Australasian shares held by PIEs on accrual basis	*No discount*	120	138	158	182	209
	10% discount	108	124	142	164	188
Option 3A taxing all shares held by PIEs on accrual basis	*No discount*	459	538	631	740	867
	10% discount	376	441	517	605	709
Option 4 - taxing Australasian shares held by PIEs on FDR basis	*5% FDR rate*	-68	-78	-90	-103	-119
	3.5% FDR rate	-128	-147	-169	-194	-223

87. Significantly, the FDR option is forecast to lose revenue over the forecast period (with more revenue lost with if the rate is cut to 3.5%). The other options by contrast raise revenue, with full accrual raising the most. While we expect this result to hold for most years, in the event of a drop in share prices this result would be reversed and FDR would raise the most revenue.

88. This reflects the fact that tax paid under the FDR model is lower, but more stable than tax paid under the accrual models. Over time however, we expect the FDR method to impose a revenue cost compared with current taxation.

Assumptions

89. We have used the following assumptions for this revenue estimate:

Table 6 - Assumptions

	Australasian shares	***Non-Australasian shares***	***Data source***
Value of shares held by PIEs as at June 2018	$10.8 billion	$35.8 billion	Reserve Bank Managed Fund Assets. For non-Australasian shares 65% of overseas assets assumed to be shares based on proportions held by KiwiSaver
Value of shares held by PIEs as at April 2021	$15.9 billion	$56.6 billion	2018 values uplifted by average fund shareholding growth over past four years
Dividend yield (including imputation credits for NZ shares)	6.7%	2.4%	NZXI All share index (5 year average) and Morgan-Stanley World index (20 year average)
Appreciation rate	3%	5%	Morgan-Stanley World index used for non-Australasian shares
Fund shareholding growth (including reinvested dividends and share price appreciation)	15%	18%	Reserve Bank Managed Fund Assets – growth of shareholdings for funds over past four years
Average tax rate	25%	25%	

90. The value of Australasian shares is likely understated and value of non-Australasian shares overstated in these assumptions. This is because Reserve Bank data does not separate Australian shares from other overseas shares.

91. The actual revenue from taxing shares on accrual is likely to be volatile, as annual asset prices will determine actual revenue.

92. The Secretariat paper *Potential revenue-neutral packages* calculates the forecast revenue from taxing shares held by managed funds on a realisation basis, rather than

under one of the above options. The Secretariat will update those estimates following decisions by the Group.

4.7 Conclusion

93. In the Secretariat's view there are 3 potential options for applying a more comprehensive tax on capital gains to MRPIEs and KiwiSaver funds:

- Option 3 - tax Australasian shares held by the fund on a full accrual basis, possibly with a discount;
- Option 3A - tax *all* shares held by the fund on a full accrual basis (possibly with a discount for Australasian shares held by the fund). This option raises the question of whether direct investors should return tax on a realised basis on their non-Australasian shares (instead of FDR). If direct investors did so, then the discount for the fund's income should also apply to all its non-Australasian shares.
- Option 4 - apply FDR to *all* shares held by the fund (ie. including Australasian shares).

94. Option 4 (applying FDR to all shares) has significant disadvantages:

- It raises significant issues regarding the creditability of imputation credits and its impact on taxation of the corporate sector.
- It would result in significantly different taxation of Australasian shares held through managed funds compared with direct investment.
- It is not clear if extended use of FDR would be efficient as it depends on how accurate the FDR rate is and whether it operates neutrally in practice.
- We also see the choice for managed funds as linked to the general choice as to whether to extend the taxation of capital gains by adopting a RFRM or by taxing the gains themselves. If the group decides to tax the actual gains for direct investors, it seems more coherent to apply the same approach to managed funds.
- Finally it should be noted that we have forecast that the FDR approach will be revenue negative for the Government. This may be surprising to those members of the public that expect a more comprehensive tax on capital gains to raise revenue rather than reduce it.

95. For these reasons, the Secretariat does not recommend the FDR option.

96. This leaves option 3 (accrual for Australasian shares) and option 3A (accrual for all shares). Both these options would:

- be workable and involve relatively low systems costs for funds in moving to the new approach. We undertook some initial consultation with the managed fund sector, and they indicated that all 3 options would be feasible for them;

- be fair, in that:

  - there would only be a single level of tax - distributions, redemptions and the sale of units could be ignored for tax purposes;

  - tax would be kept outside the fund and borne by the investors at their PIE tax rate;

  - entering and exiting investors would be treated fairly

  - wealthier taxpayers would not be benefited more than poorer ones.

  - however, an option which extended the use of FDR could be viewed as violating horizontal equity

- be efficient generally, as they would not generally prefer investment in one kind of asset over another. However option 3A (full accrual taxation) would be preferable in this respect, as they would tax all of a MRPIE's share investments the same way.

- not require investors to file tax returns.

97. One point to note is that both of these options would remove the current tax concession for investing into Australasian shares compared with other types of assets. We expect this removal will, in isolation, reduce the investment by the funds into Australasian shares. However removing the concession should improve the allocation of investments from the savers' and New Zealand's perspective.

98. The Secretariat considers both options to be viable. The full accrual option also raises the question of whether direct investors should account for any gains on their non-Australasian shares on a realised basis (rather than under FDR, as currently).

99. We note that the Group's interim decision was for FDR to be retained for direct investors. However this was before the position of managed funds was considered. Accordingly there may be merit in revisiting this decision, in order to tax direct investors consistently with managed funds.

100. We set out the options for the combined taxation of direct investors and funds in the table below, with their advantages and disadvantages. The Secretariat does not have a concerted view as to which option is preferable. Instead, the Secretariat recommends that wider consultation of these options is undertaken by the Government with the managed fund sector and the public, following publication of

the Group's final report, in order to establish which method would be best for New Zealand.

101. We note however that if FDR is to be retained, then consideration should be given to extending it to all Australian shares (ie. including the listed Australian shares that are not currently subject to FDR). The decision to exclude listed Australian shares from FDR was a compromise, which does not seem coherent following the introduction of a more comprehensive tax on capital gains. The Secretariat will provide the Group with further advice on this issue in its upcoming paper on international taxation.

Table 7 – Options for combined taxation of direct and indirect investors

		Managed funds	Direct investors	Advantages and disadvantages
New Zealand shares		Tax on a full accrual basis	Tax on a full realisation basis	This is workable for the funds and produces a similar result as for direct investment.
Foreign shares	**Option A (This is Option 3 for funds, with direct investors also taxed under FDR)**	Tax under FDR	Tax under FDR	This would align the taxation of managed funds with direct investors, and would involve the least change to the current tax system. However it would involve taxing Australasian and non-Australasian shares differently for both direct investors and funds. If the FDR rate is lowered at the same time gains on Australasian shares become taxable, investors may shift from Australasian shares into foreign shares, which could affect New Zealand's capital markets.
	Option B (This is Option 3A for funds, with direct investors taxed on a realisation basis)	Tax on a full accrual basis	Tax on a full realisation basis	This broadly aligns the taxation of both direct vs indirect investment, and Australasian vs non-Australasian shares. It also has the benefit of giving a good tax treatment for hedging for funds. On the downside it allows for deferral on foreign shares held by individuals and can give rise to some difficult technical issues around demergers and share splits. It would also involve cashing out all foreign share losses to managed funds.
	Option C (This is option 3A for funds, with direct investors taxed under FDR)	Tax on a full accrual basis	Tax under FDR	This avoids deferral for individuals and gives good hedging for funds. It also taxes managed funds the same way on all their share investments. However it does create a different tax treatment for direct vs indirect investment in foreign shares.

5. Listed PIEs owning shares

5.1 Background

102. Listed PIEs are a particular type of PIE for tax purposes. The category was introduced in recognition of the fact that listed funds may have more difficulty complying with the MRPIE daily income attribution requirements, given the frequent trading of their shares/units. Accordingly the listed PIE regime was introduced to produce a similar overall tax result as MRPIEs, without the need for attribution of income to investors.

103. Listed PIEs are subject to the same restrictions as MRPIEs in terms of their permissible investors and investments. Accordingly, listed PIEs are also essentially required to be widely held managed funds. Somewhat confusingly a PIE that is listed may also choose to be an MRPIE, so not all PIEs that are listed are classed as "listed PIEs" for tax purposes. However practical reasons mean that nearly all listed PIEs are in fact "listed PIEs" for tax purposes.

104. The amount invested in listed PIEs is generally much smaller than the amount invested in MRPIEs. However, listed PIEs are a particularly significant feature of the property sector. The reason for this is at least in part because property investment is not easily divisible and is less liquid than other forms of passive investment. In this chapter we focus on listed PIEs owning shares, and deal with those owning property in the next chapter.

5.2 Tax treatment

105. A listed PIE does not attribute income to investors and its tax liability is not determined by reference to the investors' PIE tax rates. Instead the listed PIE pays tax on its income at the flat company tax rate of 28%. A listed PIE itself is taxed under the same basic rules as a MRPIE – in particular listed PIEs are not taxed on gains from selling Australasian shares.

106. Listed PIEs generate imputation credits and impute dividends like ordinary companies (although listed PIEs are required to impute dividends to the extent of their available credits). No tax is paid by shareholders on unimputed dividends from a listed PIE. Shareholders can choose whether or not to be taxed on an imputed dividend (and receive the benefit of the attached credits) from a listed PIE. This allows resident shareholders on a lower marginal tax rate to incur overall tax on their distributed income at their marginal tax rates, rather than at 28% (as they can offset their excess credits against their other income). At the same time it allows shareholders on a 33% marginal rate to receive the dividend free of tax (thus effectively capping their tax rate at 28%, the same as for MRPIEs).

Example 6

A listed PIE earned $200 of income, paid $56.00 of tax (at 28%) and paid out the remaining income as a fully imputed dividend. $72.00 in cash and $28.00 in credits was paid to an investor on a 33% marginal rate and $72.00 in cash and $28.00 in credits was paid to an investor on a 17.5% rate. The tax outcomes are as follows:

- The investor on a 33% rate does not elect for the dividend to be taxable, and so receives $72.00 in cash post tax with no imputation credits. Accordingly their $100 share of the listed PIE's pre-tax income is taxed at 28%.

- The investor on a 17.5% rate elects for the dividend to be taxable. The tax payable is $17.50 (being imposed on the gross dividend of $100). The investor claims a tax credit of $28.00 from the $28.00 of attached imputation credits. This tax credit fully discharges the investor's $17.50 of tax on the dividend, with $10.50 left over to be offset against the investor's other income. This means the total tax payable on the investor's share of the listed PIE's $100 pre-tax income is:

  $100 income - $28.00 company tax + $28.00 imputation tax credit - $17.50 tax liability on the dividend = $17.50.

  Therefore the 17.5% investor pays tax on their share of the listed PIE's income at their 17.5% marginal tax rate, rather than at the 28% company rate.

107. Shareholders who sell shares in a listed PIE are taxable if they hold them on revenue account, but not otherwise.

5.3 Options for listed PIEs

108. There are 2 viable options for applying a more comprehensive tax on capital gains to listed PIEs:

- Use the same method as for MRPIEs; or

- Tax the listed PIE on a realisation basis, like an ordinary company.

Option 1 – same method as for MRPIEs

109. The starting point is to tax listed PIEs the same way as MRPIEs in respect of their capital gains. Accordingly listed PIEs would be taxed on their Australasian share gains on a full accrual basis, and on their non-Australasian share gains under either FDR or on a full accrual basis (depending on what option is chosen for MRPIEs). The listed PIE would generate imputation credits on payment of this tax, which could be distributed to investors.

110. Under this approach, investors in the listed PIE would not be subject to tax on any distributions or redemptions by the listed PIE, or on any gains made from selling their shares. This is because the listed PIE would have paid all the tax on its income on an accrual basis. This tax treatment would also apply to MRPIEs that invested in listed PIEs, so the MRPIE would not need to return any income in respect of its shareholding in the listed PIE.

111. Applying the same tax treatment to listed PIEs as MRPIEs would be beneficial in terms of horizontal equity, as it would tax similar funds in the same way. It would also simplify the tax system, by not including separate tax regimes for different vehicles.

112. Further the intent of the listed PIE regime is to produce as similar a tax outcome as for MRPIEs as possible, without requiring the attribution of income to the listed PIE's shareholders. This implies that listed PIEs and MRPIEs should be taxed on their share gains in the same way.

113. This option generally produces the same advantages and disadvantages as the corresponding tax treatment does for MRPIEs. In particular this option:

- Would be workable and involve low systems costs for funds in moving to the new approach.
- Would be fair, in that:
  - there would only be a single level of tax - distributions, redemptions and the sale of units could be ignored for tax purposes;
  - tax would be kept outside the fund and borne by the investors at their PIE tax rate;
  - it should also be fair for entering and exiting investors. To the extent market pricing of the shares takes any accrued capital gains into account during the year, it should also take into account any tax on those gains;
  - wealthier taxpayers would not be benefited more than poorer ones; and
  - the listed PIE would be taxed the same way as MRPIEs, to which they are intended to be akin.
- Would be efficient, as it would tax listed PIEs the same way as MRPIEs. Accordingly it should not affect capital markets any differently than the same option would for MRPIEs.
- Would not require investors to file tax returns (including when they sell their shares), unless they are on a lower tax rate than 28% and elect to do so.
- Would result in a different tax treatment as compared with direct investment (as capital gains would be taxed on accrual rather than realisation). However it does not seem possible to avoid some difference between direct

and indirect investment for listed PIEs, and the difference could be minimised by setting the rates or discounts at the appropriate level.

114. There do not seem to be any additional disadvantages to applying the same approach to listed PIEs as for MRPIEs. In particular listed PIEs invest in the same types of assets as MRPIEs, so the valuation and liquidity issues of an accrual system are similarly not an issue for them.

Option 2 – tax the listed PIE on a realisation basis like an ordinary company

115. The other option would be to tax a listed PIE on its gains on a realised basis. This would be feasible for a listed PIE, as it would not need to attribute those gains to its investors, and it pays tax at a single rate. This approach essentially treats the listed PIE the same as an ordinary company, rather than as an MRPIE.

116. The advantage of this option is that it taxes on realisation, which is the same way a direct investor would be taxed. However the option has the following disadvantages compared with option 1:

- It taxes listed PIEs differently to other managed funds such as MRPIEs. Listed PIEs invest in a portfolio of passive investments, and so are more of a substitute for investing in another type of managed fund than investing directly in the shares of a single company.

- It results in 2 layers of tax, and therefore potential temporary double taxation (and double deductions). This is because a listed PIE would be subject to tax when it realises an investment, while the investor would also be subject to tax when it sells the units for a price reflecting the gain on that investment. The double tax would reverse when the listed PIE made a fully imputed distribution of its realised gain and the investor sold its units. However double tax would have been paid until the distribution and sale occurred. We include a detailed example of how this would work in Appendix B.

  This would make the taxation of a listed PIE worse than the taxation of a direct investor (notwithstanding the similar realisation basis). This is the same issue as for ordinary companies. However a listed PIE is in a different position to an ordinary company, as it is intended to produce a similar tax result as direct investment and investment through a MRPIE.

- Tax on gains on the sale of the shares would need to be reduced to 28% for 33% investors, as the investor is only intended to be taxed on 28% on its income from the listed PIE. This is possible, but would complicate taxation.

- If the listed PIE is taxed on its non-Australasian shares under FDR, it would not be appropriate to tax an investor on a gain from selling shares in

the listed PIE to the extent the gain related to non-Australasian shares held by the listed PIE and the gain exceeded the FDR income. This is because any gain on those shares above the FDR income is intended to be exempt. Consequently the gain also needs to accrue to the investor on an exempt basis. Otherwise, for a person investing in foreign shares through a listed PIE, the FDR would be a *minimum* tax, with any gain above that also becoming taxable (as a capital gain when the investor sold its shares). However for listed PIE shareholders, it would be very difficult to apportion out the part of the gain relating to returns on FDR shares in excess of FDR income when they sell their shares. Consequently investors in a listed PIE would probably be over-taxed in respect of FDR shares held by the listed PIE. This would be unfair, and inefficient, in that it would discourage listed PIEs from investing in FDR shares, and would discourage investors from investing in FDR shares through a listed PIE.

- It would require taxpayers to file income tax returns when they sold their shares.

5.4 Conclusion

117. Option 1 (same treatment as MRPIEs) is a viable option for taxing listed PIEs. Option 2 (ordinary company taxation) has some disadvantages by comparison. In particular it involves 2 layers of tax, and so involves temporary double taxation (and double deductions for losses). It also requires investors to file tax returns when they sell their units and results in the over-taxation of income from non-Australasian shares taxed under FDR.

118. Therefore option 2 results in a worse tax outcome than both direct investment and investment through a MRPIE. Given that listed PIEs are intended to produce the same tax outcome as direct investment and investment through a MRPIE (so far as possible), the Secretariat recommends option 1. Under option 1 listed PIEs would be taxed the same way as MRPIEs in respect of their share gains, and investors would not be taxed on any gain from selling their shares in the listed PIE.

6. Property owning PIEs

6.1 Background

119. Property owning PIEs are not a separate type of PIE, the way MRPIEs and listed PIEs are. Instead property owning PIEs are a MRPIE or a listed PIE that invests directly in commercial property. We understand that most property PIEs are listed PIEs, although there is a small number of MRPIEs that own commercial property. Property owning PIEs typically do not invest in other types of assets.

120. Property owning PIEs are currently taxed the same way as other listed PIEs or MRPIEs. The only difference is that property related losses are ring-fenced against income from property for MRPIEs that do not value daily.

6.2 Options for taxing the capital gains of property owning PIEs

121. There are 5 options for taxing the capital gains of property owning PIEs:

- Option 1 - full accrual taxation of the property PIE, and no taxation of the investor. This would result in the PIE having insufficient income to pay its tax liability. This creates practical difficulties for the PIE.

- Option 2 - realisation based taxation of both the property PIE and the investor (as with an ordinary company). Within this option, an issue arises for listed PIEs as to whether the current tax treatment of distributions should continue, or whether distributions should be taxed the same way as distributions by an ordinary company.

- Option 3 - realisation based taxation, but at the investor level only. This creates a significant compliance risk, as all the tax needs to be collected from the investors.

- Option 4 - realisation based taxation, but at the PIE level only. This results in significant under taxation of investors on their capital gains.

- Option 5 - for MRPIEs, taxation like a partnership (listed PIEs would be taxed under another option).

122. The Secretariat considers that Options 1, 3, 4 are not desirable. We set out our reasoning for this in Appendix B.

123. This leaves options 2 and 5. We consider these below.

Option 2 – company taxation

124. Under this option, the property PIE would be taxed like an ordinary company. It would be subject to tax on any capital gains on a realisation basis. Likewise its

investors would also be subject to tax on any capital gains they make on the sale of their interests in the property PIE. However any income untaxed at the PIE level could be distributed to the investors free of any tax on receipt. Instead, the untaxed distributions would reduce an investor's cost base in their units. Accordingly, the untaxed distributions would still be taken into account in determining the investor's gain when it sold its interests in the PIE.

125. The main problem with this approach is that it can result in temporary double taxation (and double deductions). We discussed this issue in chapter 5 in relation to taxing listed PIEs as an ordinary company. We also include a detailed example of how it works in Appendix A.

126. While this is the same problem as for ordinary companies, it is exacerbated in the case of a property PIE, which derives most or all its value from the value of its capital assets (meaning that most of the gains in value of its shares will also be attributed to the gain in value of its capital assets), and which will accrue those gains over a relatively long time.

127. Nevertheless, this particular consequence of applying ordinary corporate taxation to a listed property PIE appears to be the way widely held property vehicles (commonly referred to as real estate investment trusts or REITs) are taxed in other countries. It also has the merit of consistency with the corporate tax regime.

128. Possibly of more concern is the treatment of unimputed dividends paid by a listed property PIE. If depreciation deductions are allowed for buildings, the result can easily be unimputed dividends. One of the drivers for the listed PIE tax regime was to allow unimputed dividends to be paid out without triggering tax to the investor. This produces the same tax outcome as if the investor held the property directly.

129. The property PIEs we consulted with in preparing this paper indicated that the taxation of unimputed dividends was the most important issue for them, being more important than the possibility of temporary double taxation. This reflects the fact that property PIEs are an income stock, meaning most investors invest in them for a steady income stream, rather than for capital gains.

130. Under a capital gains tax regime, there is a strong argument for taxing such distributions. If they are not taxed, a fund can easily reduce the tax payable by its investors on sale of their shares by paying unimputed dividends, since these reduce the value of its shares. The principled response to this possibility is for unimputed dividends to reduce a direct shareholder's cost base in their shares.

131. There is a compliance risk that this kind of adjustment may not be reliably implemented by shareholders, particularly at a retail level. On the other hand, we would expect investors in single sector funds, like property PIEs, to be more sophisticated than the average investor in a managed fund. Accordingly the Secretariat considers this risk to be acceptable.

132. This option can be used for both listed PIEs and MRPIEs. Listed PIEs would just be taxed like ordinary company. The only exception is that any unimputed dividends would be untaxed on receipt by the investor, and would instead reduce the cost base of the investor's shares.

133. For MRPIEs, tax would also be payable on any gain arising when the MRPIE sold its property, or an investor sold its units. Where the MRPIE sold its property, the gain would be attributed to the investors and taxed at their PIE tax rate. Any income untaxed at the MRPIE level could continue to be distributed to direct investors free of tax. To prevent permanent double tax (or double deduction of losses), a direct investor would adjust the cost base of their units each year to reflect the difference between the amount of income attributed to them, and the amount of income distributed to them. Specifically, the cost base of an investor's units would be:

- increased by the amount of income attributed to the investor under the MRPIE rules; and

- reduced by the amount of income distributed to them by the MRPIE.

134. This is the way the Australian attributing managed investment trusts are taxed (as discussed below). The property PIEs we consulted with in preparing this paper indicated that it would be workable.

135. MRPIEs and other managed funds that invest property PIEs under this option would continue to be taxed on their investments on a full accrual basis. Accordingly they would effectively be taxed on any distributions, and would not make any adjustments to the cost basis of their interests in the MRPIE for unimputed dividends. This is to align the tax treatment of investment in a property PIE with the tax treatment of investment in other asset classes by a MRPIE. In addition, MRPIEs would also not be able to track the cost base adjustments to their interests in the property PIE without significant systems investment.

Option 5 – Partnership taxation

136. This option would apply to property MRPIEs only. This option is the most theoretically pure of the options. It involves treating the investors as if they directly held the fund's underlying investments (like a partnership). Accordingly a sale of an asset by the fund would be treated as a sale by the underlying investors. Likewise when the investor exits (by sale or redemption) the investor would be treated as selling its share of the fund's assets to the other investors. These would all be realisation events, and so would all result in taxable income or loss for the exiting investor.

137. This tax treatment would also theoretically result in income or loss for a remaining investor when another investor entered or exited. However it might be possible to suspend such gain or loss until the remaining investor exited themselves, or the relevant assets were sold by the PIE.

138. The disadvantage of this approach is that it requires complicated calculations and record keeping by the PIE. The main complexity arises from treatment of redemptions, subscriptions and sales. All of these events will require basis adjustments for all the investors in the PIE. The treatment of subscriptions is particularly problematic, as it will prima facie require recognition of gain or loss by investors who are not themselves transacting.

139. Nevertheless, because property MRPIEs have fewer transactions, both in terms of their own assets and at the investor level, than other MRPIES, this may be a viable option for them. In particular most property MRPIEs are closed, meaning they do not issue or redeem units after inception. They also restrict sales of units to the start of the next valuation period. This significantly simplifies the required calculations.

140. This approach would only apply for direct investors in a property MRPIE. Managed funds investors would continue to account for their investment in a property MRPIE on a full accrual basis.

141. However this option will not work for open ended MRPIEs (of which there is one). Listed PIEs would also need to be taxed under another option.

6.3 International comparison

142. We set out the tax treatment of property investment funds in some other countries in appendix D. Our recommended options are similar to the regimes in Australia, Canada, and the US, in that they tax property PIEs on both levels and adjust the investor's cost bases. However for listed PIEs we will avoid double taxation under our imputation system, rather than under the attribution or deductible dividend methods used in those countries.

6.4 Conclusion

143. For listed property PIEs, the Secretariat recommends option 2 (company taxation), with the following modifications for direct investors:

- No tax on unimputed distributions. The Secretariat notes that the current limit on the taxation of distributions should ideally be removed, so that they can be taxed at up to 33%, just like other dividends and capital gains earned by a direct investor on that rate. This is the best approach to equalise direct and intermediated investment. However recommending an increase in the rates of any income tax is outside the Terms of Reference for the Group.

- Unimputed distributions to reduce an investor's cost basis in their shares, thus increasing the investor's taxable gain on their eventual sale of the shares. Consideration should be given to how to ensure basis adjustments are made by investors when they come to sell.

144. Managed funds would be taxed on their investment in a property PIE on a full accrual basis. Any income attributed to them by a property MRPIE would be ignored. They would not undertake any cost basis adjustments to their interests in a listed PIE (or a MRPIE electing the same option as a listed PIE).

145. For property owning PIEs that are MRPIE's, option 5 (partnership taxation) should result in the same tax result as direct investment in property, with few disadvantages. However it is complex (although much less so than for ordinary MRPIEs) and will require property owning PIEs to incur systems costs to comply with it. It also will not be feasible for an open ended property MRPIE.

146. Therefore the Secretariat recommends property MRPIEs be given the option of applying option 2 (company taxation) as an alternative to option 5.

7. Superannuation Funds

7.1 Background

147. Superannuation funds are retirement savings vehicles that are not generally under the KiwiSaver regime (although 2 superannuation funds are in the KiwiSaver regime). Superannuation funds are typically trusts, and have trust deeds which govern their operations. Superannuation funds are also regulated under the Financial Markets Conduct Act 2013.

148. Superannuation funds can be taxed like a PIE, or be taxed under the trust rules. This chapter considers the tax treatment of superannuation funds that are not taxed as a MRPIE (as the appropriate tax treatment of capital gains earned by MRPIE superannuation funds will be the same as for other MRPIEs).

149. Superannuation funds can either be defined benefit (where the investor receives a fixed payment entitlement) or defined contribution (where the investor has an interest in the underlying assets of the fund in proportion to their contributions). Defined benefit funds are now a legacy product, with most superannuation funds being defined contribution.

150. An investor's savings are locked into a superannuation fund until retirement age. It is possible for investors to switch superannuation funds. However they do not sell their superannuation entitlements to other investors. This means investors enter by investing in the fund, and exit by withdrawing that investment. For this reason superannuation funds need to regularly value their investments.

151. The investment profile of non-KiwiSaver superannuation funds is as follows[25]:

Table 8: Investments by Superannuation funds - June 2018

Column 1	Column 2 (in $millions)
Total assets	**28,648**
New Zealand assets	12,831
Overseas assets	15,818
New Zealand assets	
Cash and deposits	906
Debt securities	1,591
Equities and units in trusts	10,149[26]
Other assets[27]	184
Overseas assets	

25 These figures are derived from the Reserve Bank of New Zealand series T44 – other registered superannuation

26 This includes investments in other asset classes made through a NZ managed fund

27 These comprise: loans ($9 million); derivatives ($8 million); other financial assets ($68 million); and non-financial assets ($99 million).

Cash and deposits	78
Debt securities	3,111
Equities and units in trusts[28]	12,429
Other assets[29]	199

152. Superannuation funds invest primarily in debt securities and equity securities, with slightly more invested offshore than onshore. Superannuation funds have very low investment in non-financial assets.

153. 344,759 people had an interest in a superannuation fund in December 2015 (down from 508,195 in December 1990 and 363,123 in December 2014)[30]. By comparison 2,608,383 people that an interest in a KiwiSaver fund in June 2016[31]. Accordingly seven times more people save for retirement through KiwiSaver than through superannuation funds (ignoring any cross-holdings).

154. Superannuation funds vary greatly in size. There were 438 non-wholesale funds in total, 288 of which had an asset value of less than $5 million (and 127 with a value of less than $500,000). However 92% of all superannuation fund assets, and 90% of all members, are in the 69 superannuation funds with more than $50 million in assets.

155. Of the 438 total non-wholesale funds, 238 were private (ie. set up by individuals for themselves and their family), 147 were employer funds, and 53 were retail funds. There were 8 wholesale funds (ie. schemes into which other superannuation funds invested[32]).

156. The above figures to not distinguish between superannuation funds that are taxed as PIEs, and superannuation funds taxed under the trust rules. We would expect the investment mix to be similar across both types. However these figures will not be accurate in relation to the size and number of the non-PIE superannuation funds.

157. We would expect the 288 superannuation funds with less than $5 million of assets to be taxed under the superannuation tax regime rather than the PIE regime. This is due to the compliance costs of the PIE regime, along with its widely-held investor requirements. (None of the 238 private superannuation funds should be able to qualify as a PIE for example.)

158. Inland Revenue's own data shows that there were 472 entities that returned tax as a superannuation fund for the 2017 tax year (down from 752 for the 2007 income year). The average combined annual taxable income for these entities for the 2015 - 2017 tax years was $321m (compared with $1,051m for the years 2005-2007). The

[28] The data does not differentiate between Australian listed shares and other foreign shares.

[29] These comprise derivatives ($180 million), other financial assets ($18 million) and non-financial assets ($1m).

[30] Financial Markets Authority *Superannuation Scheme Statistics (for the year ended December 2015),* 6 July 2016

[31] Financial Markets Authority Kiwi Saver Annual Report (*1 July 2015 – 30 June 2016),* 6 July 2016

[32] Financial Markets Authority *Superannuation Scheme Statistics (for the year ended December 2015),* 6 July 2016

total assets held by non-PIE superannuation funds is most likely in the range of $4,000 million – $8,000 million[33] (compared with total superannuation fund assets of $27,474 million for the March 2017 quarter).

7.2 Current tax treatment

159. Superannuation funds that are not PIEs are taxed under the complying trust rules. Widely held superannuation funds pay tax on their income at 28% (others pay tax at the normal trust rate of 33%). Distributions to investors and redemptions are not taxed. The superannuation fund calculates its taxable income under the ordinary tax rules.

7.3 Options for taxing capital gains

160. There are two options for extending the taxation of capital gains to superannuation funds:

- Option 1 - tax the same way as an MRPIE; and
- Option 2 - tax on a realisation basis.

Option 1 – MRPIE taxation

161. Under this option, superannuation funds would be taxed the same way as MRPIEs (that is, they would be taxed on their Australasian share gains on a full accrual basis, and on their non-Australasian share gains under either FDR or on a full accrual basis). This would have the same tax advantages and disadvantages for superannuation funds as for MRPIEs. It would also have the benefit of horizontal equity, as it would tax all managed funds (other than property PIEs) the same way.

162. We expect that this approach should be workable for the larger defined contribution superannuation funds, due to their existing need to value their investments in order to price entries and exits. We also expect it to be workable for the larger defined benefit funds, as they invest in the same type of assets as the defined contribution funds and also need to regularly value their investments and returns. However it may impose a great comparative level of compliance costs on small superannuation funds (such as the private superannuation funds).

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[33] If we assumed a 7.8% investment return (which was the average annual return in 2017 for balanced KiwiSaver funds according to the Morningstar KiwiSaver survey for March 2017), then this would imply total assets for non-PIE superannuation funds of $4,115 million. The actual assets will likely be greater than this, as not all of a superannuation fund's return will have been taxed (eg. non-realised share gains). If we compare the non-PIE superannuation fund taxable income in 2017 with 2007, and adjust for the increase in size of the market, then this would suggest that the non-PIE superannuation funds make up 25% of the total superannuation fund market in 2017, giving them a total asset size of $6,869m.

Option 2 – realisation basis

163. Under this option, superannuation funds would be taxed on a realisation basis. This would be workable, as superannuation funds do not need to attribute their income to their investors, and interests in superannuation funds are not sold between investors.

164. The fund would need to maintain a provision for deferred tax on any accrued gains, to ensure that entering and exiting unitholders were fairly treated. However this should be feasible, given that the fund pays tax on all its income at a single rate.

7.4 Conclusion

165. Either option 1 or option 2 is viable for larger superannuation funds. Option 2 (realisation) may be more appropriate for smaller funds. Although this could provide a more favourable tax treatment for smaller superannuation funds compared with larger ones, this favourable treatment would only apply to the extent that the funds own Australasian shares – all funds would still be taxed on the same basis for financial instruments and other foreign shares.

166. The Secretariat recommends option 1 (the same as for MRPIEs), with a de minimis option for smaller funds (eg less than $20 million in assets) to return tax on a realisation basis (option 2).

8. Life Insurance

8.1 Introduction

167. Life insurance companies are companies that carry on a life insurance business and are licenced under the Insurance (Prudential Supervision) Act 2010. The nature of modern life insurance companies and their business is to provide economic returns to shareholders who have contributed capital in the company.

168. The life insurer receives premiums from policyholders, which are invested or used to meet expenses and claims. The net returns from the invested funds produce returns for the shareholder, and in the case of savings policies, for the policyholder as well.

169. Certain savings policies "participate" in the profits of the life insurer. The life insurer allocates income between the participating policyholders and the life insurer's shareholders.

170. The profits from the life insurer not allocated to the policy holders are available (subject to corporate law and regulatory requirements) to be returned to shareholders.

171. This chapter looks at the investment income earned by life insurers. It does not consider the taxation of their risk business, the taxation of mutual transactions between members, or the taxation of life insurance death benefits.

172. The net assets of a life insurer are owned by shareholders. The economic rights of policyholders are determined by contracts with the life insurer and can extend to specific assets.

173. Life insurers need to value their assets regularly to deal with entering and exiting policy-holders with savings products and profit participation products.

174. There are 32 registered life insurers, however only 6 still have a policyholder base. These life insurers have approximately 200,000 life policies on issue that include a savings element.

175. The following table sets out the investment profile of the life insurance industry for June 2018 (in $millions)[34] .

[34] See the Reserve Bank of New Zealand Series T42 – Life insurance

Table 9 – investment by life insurers

Total assets	**9,283**
New Zealand assets	6,792
Overseas assets	2,491
New Zealand assets	
Cash and deposits	971
Debt securities	3,983
Equities and units in trusts	1,692
Other assets[35]	146
Overseas assets	
Cash and deposits	23
Debt securities	357
Equities and units in trusts[36]	2,091
Other assets[37]	20

176. Life insurers have a similar investment profile to the other managed funds. They invest both in New Zealand and overseas. Their investments are primarily in debt, equities and units in unit trusts. Life insurers do not typically hold any non-financial investments, although some retain legacy assets, such as buildings (although these are a very small proportion of the industry's total investments).

8.2 Current tax treatment

177. In 2010 the taxation of life insurance business was significantly reformed. The changes updated the tax rules to ensure that a life insurance business was taxed on its profits and extended the PIE marginal tax rate benefits to individuals who save through investment-linked life products, along with the exclusion for Australasian equity gains.

178. The rules place all taxpaying obligations on the life insurer but require separate calculations to reflect two bases of taxable income:

- a shareholder base (representing income derived for the benefit of shareholders); and
- a policyholder base (representing income derived for the benefit of policyholders).

179. The **shareholder base** consists of:

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[35] These comprise: loans ($65 million); derivatives ($55 million); other financial assets ($26 million).

[36] The data does not differentiate between Australian listed shares and other foreign shares.

[37] These comprise derivatives ($19 million); and other financial assets ($1 million).

- the risk component of premiums of non-participating life policies (less the risk component of claims – net of reinsurance);
- net investment income allocated to the shareholder base;
- shareholder share of participating policy profits;
- fees for investment management and other financial intermediation services;
- income from annuities;
- income determined under ordinary principles from other sources;
- *less* expenses and commissions allocated to the shareholder base;
- *plus/less* changes in reserves

180. The shareholder base is taxed at 28% under company tax rules and dividends are imputed to the extent possible.

181. The **policyholder base** includes:

- net investment income allocated to the policyholder base;
- *less* expenses and commissions allocated to the policyholder base

182. The policyholder base is taxed at 28%, with life insurers having the option to elect to attribute investment income from investment-linked products to policyholders at their PIE tax rate. Officials note, however, that no life insurer has elected to do so do as it is uneconomic to provide PIE administration for a savings product that is in market decline.

183. The exclusion for Australasian share gains applies to the policyholder base only. The policyholder base is ring-fenced for tax losses and not subject to continuity requirements. Policyholder base tax payments do not create imputation credits.

184. Life insurers have in the past derived most of their income for the policyholder base, in part because the tax rules did not adequately tax the shareholder base. However last year they derived more income for their shareholder base than their policyholder base, and we expect this to continue in the future. The shareholder base also includes profits from the risk business, while the policyholder base only includes investment income. Therefore, life insurers do not necessarily derive more of their investment income for the shareholder base, as the legacy policyholder savings products still generate considerable investment income.

Profit participating policies

185. Special rules apply to profit participating policies, which are a special class of savings policy. Participating policies involve a group of members (policyholders) who pool their money together, generate income, bear expenses and self-insure (possibly with some outside reinsurance).

186. Profits from the business are allocated between policyholders and shareholders through a contractually agreed formula; typically 80:20. Policyholders receive their share via a bonus allocation which increases their vested entitlement to the fund. Shareholders provide a capital guarantee on these vested benefits.

187. The tax base for profit participation policies can be broadly described as investment income *less* expenses *plus* other profit. Premiums and claims are ignored.

188. The policyholder base is not taxed on other sources of gains (such as underwriting profit). "Other profit", if it arises, is included in the shareholder base.

8.3 Tax issues

189. A more comprehensive tax on capital gains is likely to impact the tax rules for life insurance business in two ways:

    - the non-taxation of gains from Australasian shares would need to be removed; and

    - the non-taxation of gains from physical assets (property) held on capital account would need to be removed.

190. Historically, life insurance business was treated as mostly on revenue account. While the changes in 2010 allowed for the non-taxation of gains from Australasian equities, Inland Revenue has not observed any substantial change in life insurer behaviour in respect of whether income is treated as being on revenue account or capital account.

191. Investments by life insurers are typically in multi-rate PIEs, because of their associated tax benefits. These investments are generally daily priced.

192. Life insurers first calculate their annual income and deductions. They then apportion those income and deductions between the shareholder base and the policyholder base. This means that a life insurer needs to use a single method to calculate its income, and then apportion that income between the bases.

8.4 Conclusion

193. Life insurers with a policyholder base are in a similar position to other MRPIEs, in that they are a pooled investment vehicle. They also hold liquid securities, which they need to price regularly (their land investments are de minimis by comparison). For this reason we recommend that they return their income from Australasian shares (and any land) on the same basis as MRPIEs and listed PIEs. This will provide a consistent tax treatment across investment vehicles.

194. We recommend the same approach be applied to the taxation of investment income earned in relation to profit-participation policies. That is, the income from the sale of Australasian shares should be calculated under the method used for MRPIEs, then apportioned between the shareholder base and the policyholder base. Because any capital income will be fully taxed at the life insurer level under this option, no consequences should arise on the cashing out of the savings component of a life insurance policy under a more comprehensive tax on capital gains.

195. Life insurers without a policyholder base are essentially ordinary companies. Therefore we recommend that these types of life insurers be taxed like on ordinary company on their capital gains – i.e. on a realisation basis.

9. Retirement Savings

9.1 Background

196. This section of the paper looks at the taxation of retirement savings more generally. It considers how the implications of taxing more capital gains on retirement savings, specifically KiwiSaver, could be addressed, particularly in relation to low to middle income earners. Consideration is also given to further incentives (both tax and non-tax related in nature) that could be introduced to encourage greater retirement savings through KiwiSaver.

197. KiwiSaver is a voluntary savings scheme aimed at encouraging New Zealanders to save for their retirement. Individuals are automatically enrolled into KiwiSaver on starting new employment and must actively choose to opt-out of the scheme if they do not wish to be a member (this opt-out period is time limited). Once a member, individuals are generally locked-in to the scheme until they reach the age of 65 (although they can withdraw their funds earlier to purchase a first home and in the case of financial hardship etc). Members are required to make contributions from their salary and wages (the minimum employee contribution rate is 3%).

198. Outside the income tax system, KiwiSaver includes a number of incentives aimed at encouraging members to save for their retirement. The main benefits are: an annual Government contribution up to a maximum of $521.43 paid at a rate of 50 cents for every dollar of member contribution (the member tax credit); and a matching compulsory contribution made by employers equal to 3% of the member's salary or wages[38].

199. The Group previously received advice from the Secretariat that any tax concessions to encourage retirement savings should be targeted at middle income earners, in order to have the most effect in terms of increasing savings[39].

200. As is generally the case with capital income in New Zealand, KiwiSaver funds are taxed on a Taxed-Taxed-Exempt ("TTE") basis. Employee contributions are made from taxed income and employer contributions are subject to an employer superannuation contribution tax (ESCT). As outlined earlier in the paper, once invested, investment earnings are typically taxed under the MRPIE regime. Compared with the taxation of other managed funds, there is currently no concessionary tax treatment for the investment income component of retirement savings in New Zealand.

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[38] While this contribution is expressed to be compulsory, salary sacrifices arrangements are permitted. These arrangements (where available) effectively move the economic cost of the employer contribution on to the employee.

[39] Inland Revenue and the New Zealand Treasury, *Taxation of Retirement Savings* (discussion paper for session 13 of the Tax Working Group) July 2018.

9.2 Implications of taxing more capital gains on the accumulation of savings in KiwiSaver

201. As discussed earlier in the paper, excluding the fact the funds are generally locked-in until a member reaches the age of 65, KiwiSaver is substantively analogous to other MRPIEs, and therefore should be subject to the same tax treatment in relation to capital gains. This would mean that KiwiSaver members' gains from their schemes holding Australasian shares would be taxed, resulting in a decrease in savings accumulated by members compared with under the current PIE tax rules.

202. It is anticipated that if no further changes were made to the taxation of KiwiSaver investments, taxing more capital gains would impose additional tax obligations of approximately $15 million per annum across KiwiSaver members with annual income of less than $48,000 and approximately $45 million per annum across high income KiwiSaver members.[40]

9.3 Proposals to address the impact of taxing more capital gains on retirement savings and boost savings for low to middle income earners

203. The Group has developed a package that would address the impact of a more comprehensive tax on capital gains for retirement savings for low and middle income KiwiSaver members. The package consists of the following two initiatives:

- Remove the employer superannuation contribution tax (ESCT) on the employer's matching 3% contribution, for KiwiSaver members earning up to $48,000 per year.

- Reduce the lower PIE rates (currently 10.5% and 17.5%) for KiwiSaver funds by five percentage points each (and consider ways to simplify the determination of a member's PIE tax rate, which is somewhat complex).

204. The combined effect of this package would be a reduction in tax of about $215 million per annum across members earning less than $48,000. This would greatly exceed the increased tax obligations on KiwiSaver investments resulting from the taxation of more capital gains for low to middle income earners (of $15 million).

205. In addition to offsetting the impact of taxing more capital gains for retirement savings invested through KiwiSaver, the introduction of these tax changes should increase accumulated net savings amongst low to middle income members. These

[40] Based on the level of domestic equities owned by KiwiSaver funds as of March 2018 and the split of income earned by lower-income and high-income members in 2016 (based on their reported PIE rate). Domestic shares are assumed to increase in value by 3% per year and share amounts grow by 20% per year. Australian shares are not included in the costings due to data limitation but they are not expected to be large compared to ownership of domestic shares due to the benefit of imputation. This does not take into account a change in investment levels made by KiwiSaver funds as a result of tax changes. Estimates are preliminary and presented for indicative purposes only.

additional savings would improve the living standards of these individuals in retirement.

206. Targeting the tax reductions at low and middle income earners, rather than extending the measures to all KiwiSaver members, should increase the overall progressivity of the taxation of retirement savings. Untargeted tax reductions are less progressive, as they proportionately benefit high income earners over low to middle earners. They would also have a significantly greater fiscal cost to the Government. Savings by the low to middle income member group are also more likely to be "new" savings (whereas additional contributions made by higher income members are more likely to be re-allocated from other savings vehicles). Furthermore, providing further incentives to high income-earners may not be necessary, as they are likely to already be saving adequately for their retirement.

207. We note that there are some practical issues with the proposal to remove ESCT on employees earning up to $48,000. Having a hard eligibility limit means employees earning $48,001 would be significantly worse off than employees earning $47,999. In addition, it will be difficult for employers to determine whether or not to pay ESCT for workers with more than one job. This raises the question of who will be liable for any ESCT that is not withheld in error under the proposal. It would make sense for the employee to be liable, as it is the employee who benefits. However this could have a harsh outcome for an employee that obtains a second job during the year, and forgets to notify their primary employer.

208. The Secretariat considers that some modifications will need to be made in the more detailed design of the Group's ESCT proposal in order to address these issues.

9.4 Further incentives from within the tax system

209. It is not proposed to address the implications of a more comprehensive tax on capital gains on retirement savings for high income KiwiSaver members via the tax system. As noted above, a broad tax reduction is less progressive than a targeted one, as higher income earners receive a proportionately greater benefit than those earning lower incomes. Opening up concessionary tax treatment to high income earners also increases the risk of KiwiSaver being turned into a vehicle for high income earners to generate large tax reductions, while contributing little to national savings levels (as they may simply re-allocate their existing savings into KiwiSaver).

210. The tax system is also limited to the extent it can encourage additional savings by low and middle income earners, as the degree to which they can take advantage of tax concessions for savings is constrained by their income. Therefore, if further incentives – beyond those discussed above – were sought to encourage savings in this group, options outside the tax system (such as additional direct Government contributions) would need to be considered.

9.5 Incentives outside the tax system

211. Compared with further intervention in the tax system, increasing the existing member tax credit would be a more progressive way to offset some of the additional tax on investments resulting from taxing more capital gains, for higher income KiwiSaver members.

212. Lower income earners proportionally receive a greater benefit from the member tax credit than members on higher income. (While all members who contribute upwards of $1,042 receive the full $521.43 member tax credit, this amount is of a proportionally greater value compared to their salary for lower income earners than it is for members on higher incomes). However, many low income earners may contribute less than $1,042 per year through KiwiSaver in which case they will receive less of a member tax credit than those who contribute at least $1,042.

213. Consideration could be given to increasing the member tax credit from $0.50 per dollar to $0.60 per dollar for all members – generating a benefit of $190 million per year spread across all members. This would offset some of the additional tax on investment for high income earners, while still maintaining the focus of KiwiSaver incentives on low income members (as they would receive a larger proportionate benefit from the incentive).

214. To further assist in boosting savings amongst low income KiwiSaver members, consideration could be given to a more substantial increase to the member tax credit (for example from $0.50 per dollar to dollar per dollar). However, this kind of measure would rely on spending decisions that are beyond the scope of the Group's Terms of Reference.

9.6 Conclusion

215. The proposed retirement savings package would involve removing the ESCT for KiwiSaver members earning up to $48,000 and reducing the lower PIE rates for KiwiSaver funds by five percentage points each. This package would result in a tax reduction of about $215 million per annum for members earning less than $48,000. This would greatly exceed the impact of increased tax obligations on these members resulting from a more comprehensive tax on capital gains. It would also improve the position of low to middle income KiwiSaver members in retirement.

216. It is not recommended that additional changes are made through the tax system to offset the impact of taxing more capital gains for high income earners, or to further incentivise savings. A progressive way to achieve this goal outside the tax system would be to increase the member tax credit amount. This would have a proportionally greater benefit for lower income members, thereby maintaining the focus of KiwiSaver incentives on lower income savers.

10. Investment restrictions

217. In the course of preparing this paper, it has become apparent that the current structure of the managed fund industry limits the kinds of investments that managed funds can make.

218. Managed funds (including KiwiSaver) need to be able to both value their investments (in order to determine unit prices) and realise them easily (in order to satisfy redemptions and transfer investors to other providers). This pushes the managed fund industry into investing in listed shares rather than unlisted shares. In fact the entire New Zealand managed fund industry holds only $500 million in unlisted shares, as against a total asset base of nearly $132 billion.

219. This heavy bias towards listed shares means that New Zealand's unlisted sector cannot obtain funding from the managed fund sector. This constrains the growth of the unlisted sector, particularly in the SME market.

220. It also means that the managed fund sector (including KiwiSaver) does not invest (except at a very low level) in certain kinds of investments which would provide benefits to New Zealanders. This includes things like venture capital, infrastructure, social housing and sustainable investment, as these types of investment typically are not typically liquid or easily valued. Only the largest funds can invest in these kinds of assets, and the size of their investment must be small to address the liquidity risk.

221. The Group may wish to make an observation along these lines, with a suggestion that work be done on allowing KiwiSaver funds at least to make these kinds of investments. For example if sustainable investments could be packaged into a listed vehicle, then the managed funds would become able to invest into them.

11. Conclusion and recommendations

222. We set out over the page a table summarising the different options for each type of managed fund, together with the Secretariat's recommendation.

223. We request that the Group decides which option to recommend for each type of fund.

224. We also request the Group decide, if it elects for accrual taxation of Australasian shares, whether a discount should be applied to the income calculated under that method. This discount would reflect the time value of money disadvantage of a managed fund accounting for its gains on an accrual basis, compared with a direct investor accounting for its gains on a realised basis.

	KiwiSaver / Multi-rate PIE (MRPIE)	Listed PIE (non-land)	Land owning PIE (listed and multi-rate)	Superannuation (defined contribution)	Life insurance
Key features	- Invest in shares and financial instruments, both in New Zealand and overseas - Do not invest directly in land (may invest in other funds that hold land) - Assets are liquid (large funds may hold a small portion of illiquid assets) - Regularly value their assets to price their units - Investors enter and exit by buying or redeeming units. Sale of units between investors is uncommon/not permitted - For KiwiSaver, investors cannot generally access their funds until retirement age, but may transfer their funds between providers	- Invest in the same kind of assets as MRPIEs - Do not typically redeem - Still regularly value their assets to price their units - Investors generally enter and exit by selling shares between themselves - Shares are regularly traded	- Invest primarily in commercial property, and (assume) hold for longer periods - Assets are illiquid - Do not redeem units. - Investors enter and exit by selling shares or units between themselves - Earn rent and capital gains - For accounting and valuation purposes, assets are often revalued to market, usually quarterly or annually - For multi-rate PIEs, trading is often restricted to windows around valuation	- Invest in the same kind of assets as MRPIEs - Investors enter by subscribing for units and exit by redeeming their units - Investors do not sell their units - Investors are locked into the fund until retirement age	- Invest in the same kind of assets as MRPIEs - Investors can save through savings-linked policies and profit participation policies - Allocate investment income between shareholder base and investor (policyholder) base - Policies are not traded, but can be cashed in for their surrender value - Value investments regularly to calculate policyholder entitlements - 6 out of 32 registered life insurers have a policyholder base
Current tax treatment	- Attribute income to investors and pay tax on the attributed income at an investor's prescribed investor rate (PIR) - Gains from Australasian shares are exempt - FDR on other shares	- Taxed like a company, except gains on Australasian shares are exempt, unimputed dividends are not taxed to shareholders, and shareholders can elect to be taxed on imputed dividends - FDR on non-Australasian shares	- Taxed as a MRPIE or listed PIE - The properties are typically held on capital account, so gains on them are not taxed	Taxed like a trust except all income is trustee income taxed a 28% for widely held funds (33% otherwise), and distributions are exempt - Gains on Australasian shares are taxed on realisation, except for passive tracker funds - FDR paid on non-Australasian shares	- Investment income divided between the shareholder base and the policyholder base - Shareholder base taxed like an ordinary company - Policyholder base taxed at 28% on its share of the investment income - All tax paid by the life insurer

Options for taxing more capital gains	Option 3 - accrual for Australasian shares (including unlisted NZ shares), and FDR for other shares Option 3A - a full accrual basis (including foreign shares), possibly with a discount for Australasian shares. This also raises an issue as to whether direct investor should account for their non-Australasian shares on a full realisation basis (rather than FDR as currently) Option 4 - A full FDR basis (including Australasian shares) - Under all options income is attributed to investors as at present. PIE pays tax on income at investors' applicable PIRs. There is no tax for investor on any distributions, redemptions or sale gains	1. Tax the same as a MRPIE. Investors would not be taxed on redemptions, or sale gains. Dividends paid taxed to investors as currently 2. Tax the same as an ordinary company, so on a realisation basis with two levels of tax. Dividends paid taxed to investors as currently	1. Tax the same as an ordinary company, (on a realisation basis with two levels of tax). This can give rise to temporary double taxation (and double deductions) until a distribution is made and the shares are sold. There are options to reduce (but not eliminate) the time double tax applies for. For direct investors, the PIE would be allowed to distribute untaxed income, with the distribution reducing the investor's cost base 2.For MRPIE property PIEs, tax direct investors like a partnership (managed funds taxed on their interest in the property PIE the same way as for other shares under both options)	1. Tax the same as a MRPIE. 2. Tax the fund on a realisation basis - Under both options, the investor would not be taxed on distributions or redemptions under either option	1. Tax life insurers with a policy base the same way as MRPIEs (2. Tax life insurers with no policyholder base like ordinary companies
Secretariat recommends	Option 3 - accrual for Australasian shares (including unlisted NZ shares). The following options are all viable for foreign shares. The Government should consult further on which of them is best: - tax funds on a full accrual basis and direct investors on a full realisation basis - tax funds on a full accrual basis and investors under FDR - tax funds and investors under FDR.	Option 1 - tax the same as a MRPIE.	Option 1 for listed property PIEs. Option 2 for MRPIEs, with an election to use option 1 in case option 2 is not feasible.	Option 1, with a de minimis exception to allow small funds to be taxed on realisation.	- Option 2 for life insurers with a policyholder base tax in the same way as MRPIEs - Option 1 for life insurers with no policyholder base like ordinary companies

Appendix A - other options for tax treatment of funds

Introduction

1. This appendix sets out our analysis of the options we did not consider in detail in the main body of the Report.

Chapter 4 - MRPIEs

Option 1 - retain the status quo ie. exempt gains from selling Australasian shares

2. Under this option, gains from selling Australasian shares would remain exempt.

3. This option would be the most workable of all the options, as it simply preserves the status quo for PIEs. It would also be fair for entering and exiting investors, and not require investors to file tax returns.

4. However this option has several disadvantages:

   - It would put KiwiSaver and MRPIEs in a significantly better position than individuals that invest directly. This would be inconsistent with the interim decision of the Group that income earned by an individual through a MRPIE should calculated on the same basis as if an individual invested directly.

   - It would be also be inefficient. Ideally, the marginal effective tax rates on different investments should be as uniform as possible, so that taxation does not distort taxpayer choices into making inefficient choices. However this option:

     - Would distort economic decision making, by driving investors away from direct investment where this would otherwise be beneficial. For example it would create a tax disadvantage to more active investment, where the fund or individual holds a strategic stake in a company or companies. Private equity funds in particular would be seriously disadvantaged. The tax preference would severely affect the current direct investment management industry, which would not benefit from the exemption.

     - Would continue the current tax bias in favour of investment in Australasian shares rather than foreign shares and debts. This bias distorts economic decision making and reduces diversification. The current justification for this bias is the need to equalise the taxation of direct investors, who typically hold their Australasian shares on capital account, with investors through a managed fund. However with the introduction of a more comprehensive tax on capital gains to direct investors, this justification disappears.

- May affect capital markets. If managed funds are exempt on gains from NZX shares while direct investors are taxable, then many direct investors will start investing through managed funds. This reduction in the number of direct investors is expected to reduce the liquidity of the NZX. On the other hand, continuing with the exemption would probably increase the total funds invested in the NZX.

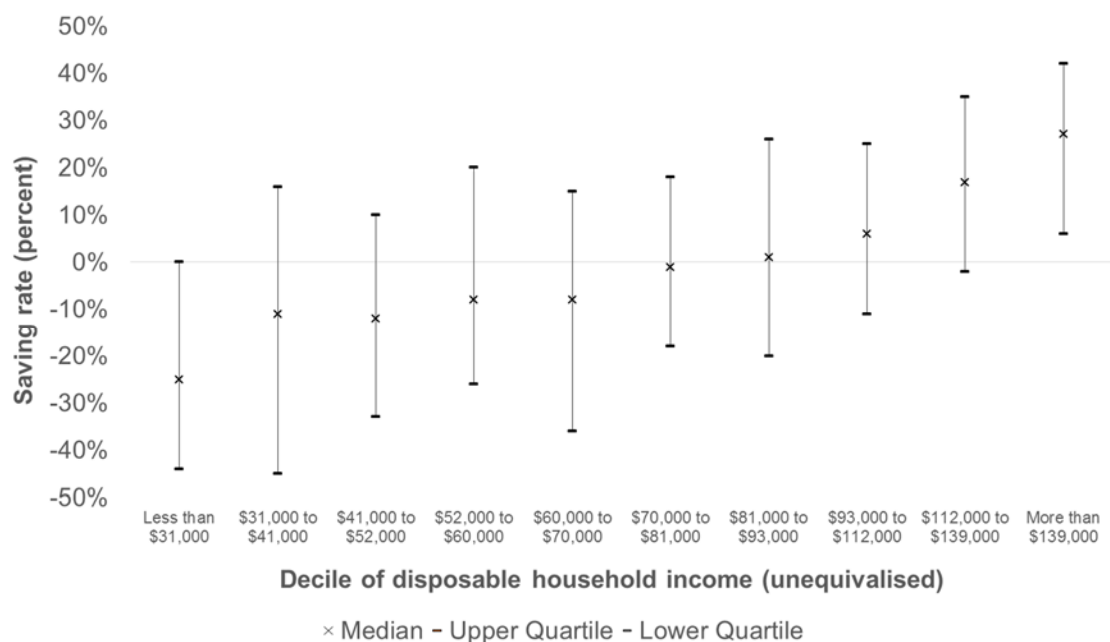
- It would unfair, in terms of horizontal equity. This is because it would:

    - tax investors differently in respect of the same type of income, depending on the legal vehicle through which they invested;

    - tax investors preferentially in respect of one type of income (gains from Australasian shares) compared to others (eg labour income).

- It would also be unfair in terms of vertical equity. The option would be regressive in comparison to the others, and would reduce the overall benefits of taxing more capital gains in improving vertical equity as higher income earners save much more than poorer households, and so would benefit much more from the exemption. This is shown by the following table[41].

Figure 2 – Savings rate per decile



41 Source: The Treasury. The distributions presented in the table only include households from the Household Economic Survey (HES) sample where the highest income earner in the household is between 30 and 60 years old, and where their data has not been excluded on the grounds of a number of outlier checks. Given these restrictions to a sub-sample of HES, results depicted will not be comparable to a similar analysis based on the entire HES sample.

Further 84% of all financial assets are owned by the top quintile (20%) of households in wealth distribution[42]. Therefore the majority of the benefit would go to the richest 20% of the population (although it would likely be a little less than 84%, on the basis that the bottom 4 quintiles probably hold a higher proportion of their financial assets through managed funds than the top quintile).

The only way to reduce this disparity would be to limit the amount that could be invested into Australasian shares. However it is difficult to see how such restrictions could be applied at the investor level, given that KiwiSaver funds and MRPIEs would be the ones investing in the Australasian shares (along with other assets) and not the investor.

- It would be inconsistent with any policy decision to adopt a more comprehensive tax on capital gains, and so would introduce a degree of incoherence into such a tax.

5. One advantage of this option is that it would incentivise investment into the NZX and unlisted New Zealand shares, by providing an exemption for any gains on them. It would also incentivise investment into the ASX, which seems harder to justify. This could be addressed by restricting the exemption to New Zealand shares, in which case another method would need to be found for Australian listed shares (such as FDR). Overall we would expect this kind of exemption to make New Zealand worse off from a financial perspective (at least in the short to medium term), as it effectively uses Government revenues to incentivise investment into products with a lower pre-tax return. For this reason the Secretariat does not generally recommend tax incentives for particular types of investment.

6. Another advantage of this option is that it could increase savings rates (but only to the extent that managed funds own Australasian shares). We note that the Group previously received advice on this subject from the Secretariat[43]. That advice reviewed studies on the effect of tax incentives on savings. According to these studies:

   - there are only weak correlations between returns to savings or tax incentives and amounts saved, including negative correlations;

   - if it is assumed that intervention to encourage savings is warranted, a general conclusion regarding the design of savings schemes is that if they are to have any effect, they should be targeted at middle income taxpayers.

7. In light of this, an exemption for Australasian shares seems to be a poorly targeted method for increasing savings, with significant disadvantages. If the Group wishes to increase savings, there are better ways to do so. In particular, any such method

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[42] See the Statistics New Zealand 2015 Household Economic Survey

[43] Inland Revenue and the New Zealand Treasury, *Taxation of Retirement Savings* (discussion paper for session 13 of the Tax Working Group) July 2018

(unlike this option) could be designed to benefit mostly middle and lower earners, without distorting the vehicles or assets into which they invest.

8. One possibility would be to limit the exemption to KiwiSaver only. This would limit some of the disadvantages, as the savings lock-in would discourage some taxpayers from switching to KiwiSaver from other vehicles to gain access to the exemption (although this would not apply to savers over 65 years old or savers who plan to use their KiwiSaver for a first home deposit). The reduced application of the exemption would also reduce the scale of the inefficiency and unfairness disadvantages.

9. However this would still not be a good policy.

   - these disadvantages would still persist in relation to KiwiSaver funds;
   - a method for taxing non-KiwiSaver funds on their Australasian shares would still need to be found;
   - the exemption would still be a poorly targeted incentive for retirement savings;
   - it would create a distinction between KiwiSaver funds and other MRPIEs. This would complicate the overall tax treatment of the sector, and impose additional reporting requirements on wholesale PIEs (as they would need to indicate which of their gains were from Australasian shares separately, so that the KiwiSaver funds could avoid returning tax on them).

10. Finally, we note that the average taxpayer or voter might struggle to understand why a more comprehensive tax on capital gains that was introduced to increase fairness included a tax exemption for stock market gains that mostly benefited the richest 20% of taxpayers.

Option 2 - tax funds on a realisation basis and attribute income to investors on a look-through basis (similar to a partnership).

11. This option is the most theoretically pure of the options. It involves treating the investors as if they directly held the fund's underlying investments (like a partnership). Accordingly a sale of an asset by the fund would be treated as a sale by the underlying investors. Likewise when the investor exits (by sale or redemption) the investor would be treated as selling its share of the fund's assets to the other investors. These would all be realisation events, and so would all result in taxable income or loss for the exiting investor.

12. This tax treatment would also theoretically result in income or loss for a remaining investor when another investor entered or exited. However it might be possible to suspend such gain or loss until the remaining investor exited themselves, or the relevant assets were sold by the PIE.

13. Option 2 has several advantages:

- It is fair for entering and exiting investors.
- It is also fair in terms of horizontal equity, as it:
    - taxes the investors the same way as if they invested directly;
    - results in a single layer of tax;
    - allows the tax to be economically passed on to the investor, but collected and returned by the PIE.
- The approach also does not raise any vertical equity or efficiency concerns.

14. The main problem with this option however is that is not workable for the great majority of PIEs. The option requires detailed and complex calculations and record keeping. A fund would need to track the value of every share it held for every investor on every day, in order to allocate the realised gains effectively and to deal with investor exits and entries. Further, investors would have different cost bases in every share. Redemptions of units, and the issue of new units, would also require adjustments to the cost bases of all the remaining unitholders and the tracking of any consequent gains or losses. This would all need to be done in the real world of MRPIEs, where units are issued and redeemed on a daily basis, and MRPIEs are frequently investing in other MRPIEs.

15. Complying with this approach would require very significant systems investment. Only a few funds would likely be able and willing to do this, meaning that KiwiSaver or other investors wanting an interest in an Australasian share fund would have a limited number of providers to choose from. Our consultation with PIEs indicated that this option would not be feasible for most of them.

16. Another issue with this approach (and any approach that involves taxing PIEs on gains or losses on shares) is that it would require the Government to pay cash rebates in respect of losses incurred by PIEs on Australasian shares. Ordinarily, tax losses are only able to be taken advantage of by setting them off against taxable income. However, a MRPIE with a tax loss can claim a cash refund, which it then attributes to individual investors. The only other workable approach to PIE losses would be to allow them to flow through to investors, which would require investors to file tax returns in order to benefit from them.

17. Currently, MRPIE losses are relatively modest, generally arising only due to defaults on loans and fund expenses. However, they will be larger if MRPIEs become taxable on Australasian shares.

18. The cash cost to Government in the case of a share market crash may be of some concern. However, this may also be seen as an advantage, since it would:

- provide a fiscal stimulus;
- constitute a very clear sharing of downside risk by the Government, which may remove an existing barrier to economically beneficial but risky investment by savers.

Option 5 – tax KiwiSaver / PIE funds directly on realised gains from Australasian shares with no attribution to investors

19. Another option is to tax the MRPIE on a realisation basis, and have the tax be a fund level expense. This would be a partial return to the pre-PIE tax system, where investment funds were generally taxed as unit trusts. It would require unit prices to be adjusted to recognize the deferred tax liability. In order for the deferred tax liability to be calculated, the tax would have to be imposed at a single rate.

20. This approach would be workable, although it would require some systems changes. The main problem with this approach is that it effectively removes the main advantages of the PIE regime for Australasian shares. This is because the option would:

    - Not tax investment through a PIE the same as a direct investment, as the tax rate would be different; and
    - Create issues of vertical and horizontal equity, as the single tax rate would be too high for low income earning investors and too low for high income earning investors, while being different from tax on similar investments.

21. Accordingly this option does not seem to be compatible with the current MRPIE regime.

Chapter 5 – property owning PIEs

Option 1 – full accrual taxation

22. This option has significant advantages. It would have the same benefits as accrual taxation for MRPIEs and listed PIEs, and it would align the taxation of all PIEs. It would not require investors to file tax returns or pay tax on gains.

23. The issue with property owning PIEs is that land is not as liquid or easily valued as the share and debt investments of other PIEs. Most property owning PIEs also hold their land for several years or more, meaning gains can accrue over a long period before the funds become available to pay the tax.

24. This raises significant issues for accrual taxation of property PIEs. A property PIE could be subject to tax on any accrued property gains in a year, but may not have the cash-flow to pay that tax. The PIE would not want to sell any property it intends to

hold on a long term basis in order to pay this tax. Accordingly such PIEs would need to raise fresh debt or equity capital in order to pay the tax on their accrued gains. In our consultation with the property PIE industry, the PIEs indicated that this would raise significant practical problems for them.

25. There would also be issues in accurately valuing those gains. In this regard we understand that all property PIEs value their properties annually for financial reporting purposes.

26. Taxing property PIEs on accrual could mean that it becomes more attractive to own commercial property through a partnership or syndicate instead as the tax on such properties will only apply on realisation when the property is sold (allowing tax to be deferred for many years). However, this is offset by the fact that PIEs have some other advantages for investors such as a 28% tax rate (instead of 30% or 33% for direct investors) and the fact that investors do not need to calculate or include PIE income in their tax returns.

27. These are the same issues which lead the group to recommend a realisation basis over an accrual based one more generally. For the same reasons, accrual taxation may be a difficult method to apply on a mandatory basis to property owning PIEs. However it could be allowed as an option for any property PIEs that wished to apply it.

Option 3 - tax the investors in the property PIE only

28. Under this approach, the property owning PIE would be taxed under the usual rules on its rental income etc. However it would not be taxed on any gain from selling its property (or be entitled to deduct any losses). Instead the investors in the PIE would be taxed on any gains from selling or redeeming their units.

29. If the PIE sold a property and distributed the proceeds, then those proceeds would not be directly taxable for an investor that pays tax on its capital gains on a realisation basis. Instead, for investors on a realisation basis, the proceeds would reduce the investor's cost base in their shares or units. If the distribution reduced the cost base below zero, then any excess would be treated as a realised gain at that time.

30. Where a MRPIE or listed PIE invested in a property owning PIE, then the MRPIE or listed PIE should be taxed on their interests in the listed PIE on the same basis as their investments on other shares (ie. on a full accrual basis or subject to FDR, depending on what the Group decides for MRPIEs and listed PIEs generally). Distributions of capital gains from the property owning PIE's sale of its property would be ignored for PIE investors.

31. This option:

- Would be workable and involve low systems costs for funds in moving to the new approach. An ordinary PIE that owned shares in a property PIE would need to identify whether its distributed income was proceeds from the sale of property or another amount. However this should not impose a significant cost, given the lower turnover of properties. In addition, PIEs would apply the same approach for their investment in the property PIE as for any other share investment.

- Would be fair, in that:

  - There would only be a single level of tax.

  - Tax would be kept outside the fund and borne by the investors at their PIE tax rate.

  - Entering and exiting investors would be treated fairly, as there would be no tax payable by the property owning PIE that could be borne by the entering investor.

  - Investment in the property owning PIE would be somewhat more favourably taxed than a direct investment in the property by an investor on a realisation basis. The investor through the PIE would be taxed the same as a direct investor, in that they only be taxed when they realised their investment (by selling their shares in the property-owning PIE), they would only pay tax on their actual gain, and there would be no second layer of at the PIE level to reduce that gain. However this option would allow the property PIE to sell existing properties and reinvest in new ones (or retain the funds within the PIE) without any capital gains tax being payable. This is equivalent to granting rollover relief for property investment by property PIEs, but not for direct investment. It would be a very favourable treatment by international standards, and by comparison to direct investors.

  - Investment in the property owning PIE by another PIE would be taxed the same way as the other PIE's investments – that is it would be fully taxable on accrual basis, with only a single layer of tax. This means that where a property owning PIE was held only by other PIEs, any gain in value of its property would be still be subject to full accrual taxation. However the tax would be returned by the other PIEs (on the gain in value of their interests in the property owning PIE), rather than the property owning PIE itself.

- Would generally be efficient, but would still incentivise investment through a property PIE where the intention is to sell and reinvest.

- Would require investors in the property PIE to file tax returns when they sold their interest in the PIE and return the income. The investors would

also need to adjust their cost bases for their interests in the property owning PIE to reflect any capital distributions. This would involve some compliance costs, but it should be manageable given the low turnover of properties. In addition we would expect most natural person investors in a property PIE to also have other share investments, and so already be required to file an income tax return.

32. The main disadvantage of this option is that it would require Inland Revenue to collect all the tax on the property activities from the PIE's shareholders, rather than the PIE. This creates a compliance and integrity risk, as it is much easier for Inland Revenue to collect tax from a single large taxpayer than many small taxpayers.

33. In summary, this option would be workable for PIEs and it would result in a broadly similar tax treatment to direct investment. However the Secretariat considers that its compliance risk would be too great for it to be desirable.

Option 4 – only tax the property owning PIE on its gains from selling the property

34. Under this option, the PIE would pay tax on any realised gains from selling its properties. However investors would not be taxable on any gain from selling their units. They also would not be taxable on any distributions, unless they elected to be so under the listed PIE regime in order to receive the benefit of any attached imputation credits.

35. This option would have similar benefits as option 3, in terms of only having a single layer of tax (and so preventing temporary double taxation and double deductions). It would also have the advantage of eliminating the need for investors in the property PIE to file income tax returns or return income when they sold their interests in the PIE.

36. The disadvantage of this option is that it would provide a significant tax concession to taxpayers that invest in property through a PIE. This is because those taxpayers would not be taxed on their capital gains from selling their interests in the property owning PIE. Accordingly they would make tax free capital gains in respect of property investment.

37. This result would also be unfair for entering and exiting investors, as the entering investor would be subject to tax on all the capital gains when the property was sold, including gains accrued before it became an investor.

38. It could be expected that the prices for units in the property PIE would be adjusted by investors to account for this tax. However it may be difficult for investors to do this, due to the uncertainty over when the property would be sold. This is a particular issue given that PIEs hold property for many years.

39. This option would still result in a significant tax concession even if investors could predict when the property owning PIE was going to sell the property, and reduce the price of the interests in that PIE accordingly. This is because the exiting investor would realise its capital gain when it sold its interests in the PIE, but the tax on that

gain would not be paid until the property owning PIE actually sold the underlying property in the future. To reflect this deferral benefit, the parties would discount the tax payable on the eventual sale of the property when pricing the units. For example:

- If investors expected the PIE to hold its properties indefinitely, then there would be no discount to the price for the interests in the PIE. Accordingly the exiting investor would realise its entire capital gain free of tax.

- If investors expected the PIE to hold its properties for another 10 years, then they would discount the expected tax payable on the PIE's accrued gain by 39.44% (assuming a daily compounding interest rate of 5%). This reflects the fact that a payment of $100 in 10 years has a net present value of $60.66 today (as a person could invest $60.66 today at a 5% interest rate and receive the full $100 in 10 years). Therefore the exiting investor would only be indirectly taxed on 60.66% of its realised capital gain.

- If investors expected the PIE to hold its properties for another 5 years, then they would discount the expected tax payable by the PIE on its accrued gain by 22.12% (again assuming a daily compounding 5% interest rate). Therefore the exiting investor would be indirectly taxed on only 77.88% of its capital gain.

40. Providing a tax concession to taxpayers that invest in property through PIEs would have all the disadvantages discussed above in relation to a tax exemption for Australasian shares. In addition the tax concession could not be limited to KiwiSaver funds, since anyone can invest in a property PIE. Finally introducing a more comprehensive tax on capital gains regime with a significant tax concession for property investment might seem particularly surprising, given that one of the perceived benefits of such a tax is to remove the current tax incentive for investing in property.

41. Therefore this option does not seem desirable.

Appendix B - temporary double taxation (and double deductions) under ordinary company model

1. The following example sets out how double tax (or double deductions) can temporarily arise under an ordinary company model which both:

   - taxes the company on any capital gains it makes on a realised basis; and

   - taxes the shareholder on any capital gains it makes from selling its shares in the company on a realised basis.

2. Suppose a company owns a single property on capital account. Shareholder A acquired 100% of the company when the property was worth $1,000. Accordingly Shareholder A paid $1,000 for its shares. The value of the property doubles to $2,000 in the next 12 months. Consequently, the value of Shareholder A's shares also doubles to $2,000 at the same time.

3. Shareholder A then sells its shares to Shareholder B for $2,000, resulting in a $1,000 taxable gain for Shareholder A. The company then sells its property for $2,000, also resulting in a $1,000 taxable gain.

4. Temporary double tax has arisen at this stage:

   - When Shareholder A sold its shares, it realised a taxable $1000 gain, which reflected the $1,000 gain in value of the underlying property. Shareholder A pays $280 tax on this gain[44].

   - When the company sold the property, it also made a $1,000 taxable gain, which is also attributable to the increase in value of the property. The company also pays $280 tax on this gain.

5. Therefore the increase in value of the property has been taxed twice at this stage – once when Shareholder A sold its shares in the company, and then again when the company sold the property. In total, $480 of tax has been paid on a $1,000 economic gain.

6. This double taxation will reverse however when the company distributes the gain (either in cash or via a taxable bonus issue) and Shareholder B sell its shares to Shareholder C. This is illustrated below.

   Cash distribution

7. The company distributes its $1,000 gain to shareholder B, in the form of $720 in cash and $280 in imputation credits. Shareholder B receives a total dividend of $1,000, but is not taxable on the dividend as its $280 tax liability on the dividend is

[44] For simplicity this assumes Shareholder B values any imputation credits generated by the company on its future sale of the property at 100%. In practice, buyers and sellers may value the credits at less than this.

offset by the $280 of attached imputation credits. The company then holds cash of $1,000, and so Shareholder B's shares in the company are also worth $1,000.

8. Shareholder B then sells to Shareholder C. The overall result is as follows.

Table 10 – Temporary double tax for cash distribution

Event	**Cost base in shares**	**Taxable income (deduction)**	**Tax (loss offset)**
Shareholder A purchases shares for $1,000	$1,000	-	-
Company's property increases in value to $2,000	$1,000	-	-
Shareholder A sells its shares to Shareholder B for $2,000 and pays tax on the gain	$1,000 for shareholder A $2,000 for shareholder B	$1,000	$280
Company sells property for $2,000 and pays tax on $1,000 gain	$2,000	$1,000	$280
Company distributes $1,000 gain ($720 cash plus $280 imputation credits) to Shareholder B	$2,000	$1,000	$0 ($280 tax - $280 imputation credits)
Shareholder B sells its shares to Shareholder C for $1,000 and claims loss	$2,000 for Shareholder B $1,000 for Shareholder C	($1000)	($280)
Total tax			**$280**

9. Accordingly the final position is that $280 of tax has been paid on a $1,000 economic gain.

Taxable bonus issue

10. A taxable bonus issue is an issue by the company of further shares which the company elects to be taxed as a dividend. Under this approach, instead of distributing its $720 after-tax profit as a fully imputed dividend, the company reinvests that profit into another property (together with its $1,000 starting capital).

This leaves the company with a property worth $1,720 and accumulated imputation credits of $280 (from the $280 of tax it paid on sale of the first property).

11. The company would then undertake a taxable bonus issue. Under this it would issue a further $720 of shares in itself to Shareholder B, with $280 of attached imputation credits (making a $1,000 gross dividend). After this, Shareholder B would have a cost base of $2,720 in its shares, but the company would be worth $1,720.

12. Shareholder B then sells to Shareholder C. The overall result is as follows.

Table 11 – Temporary double taxation for a bonus issue

Event	**Cost base in shares**	**Taxable income (deduction)**	**Tax (loss offset)**
Shareholder A purchases shares for $1,000	$1,000	-	-
Company's property increases in value to $2,000	$1,000	-	-
Shareholder A sells its shares to Shareholder B for $2,000 and pays tax on gain	$1,000 for shareholder A $2,000 for shareholder B	$1,000	$280
Company sells property for $2,000 and pays tax on gain	$2,000	$1,000	$280
Company reinvests $1,720 after tax sale proceeds in a new property	$2,000	-	-
Company makes a $1,000 taxable bonus issue to Shareholder B ($720 shares, $280 imputation credits)	$2,720	$1,000	$0 ($280 tax - $280 imputation credits)
Shareholder B sells its shares to Shareholder C for $1,720 and claims loss	$2,720 for Shareholder B $1,720 for Shareholder C	($1000)	($280)
Total tax	**-**		**$280**

13. Accordingly the final position is that $280 of tax has been paid on a $1,000 economic gain.

Conclusion

14. From this we can see that temporary double taxation (or double deduction of losses) can arise under an ordinary company model. This occurs when a shareholder sells shares in a company pregnant with a capital gain, and the company then sells the underlying property. However this double taxation reverses when the company distributes its gain, or makes a taxable bonus issue, and the existing shareholder sells its shares.

Appendix C - suggested text for Final Report

Introduction

1. The managed funds industry in New Zealand is significant. It holds assets worth $132 billion, which represents 10% of all New Zealand savings. The KiwiSaver managed fund regime is also the main way most New Zealanders save for retirement.

2. Managed funds provide several benefits, such as diversification (particularly for the less wealthy), ease of investment, and the expertise of the manager. Accordingly it is important that a more comprehensive tax on capital gains does not act as a disincentive to investment in managed funds compared to direct investment.

3. At the same time, it is also important that investment through managed funds not be heavily advantaged compared with direct investment. This is because a reduction in direct investment would also reduce the liquidity of New Zealand's capital markets.

4. Extending the taxation of capital gains to managed funds should also be consistent with the current portfolio investment entity (PIE) regime, if possible. In particular, for KiwiSaver funds and other multi-rate PIEs, it should not affect

    - the imposition of only one level of tax;
    - the imposition of tax at portfolio investor rates;
    - the calculation of tax on the same basis as if an individual invested directly;
    - the PIE's ability to effectively pass on to an investor the tax it pays on behalf of that investor.

5. There are several different types of managed funds, with different tax treatments. A more comprehensive taxation of capital gains needs to be considered separately in respect of each type. According, the Group has considered how a tax on more capital gains could apply to:

    - multi-rate PIEs (MRPIEs), which includes KiwiSaver funds;
    - listed PIEs that own shares and financial instruments (for funds listed on the stock exchange);
    - property owning PIEs (these are either listed PIEs or MRPIEs, however they involve different considerations due to their investment in land rather than more liquid shares and financial assets);
    - superannuation funds;

- life insurance funds.

6. There are several options for extending the taxation of capital gains for each type of fund. We have reviewed these options and assessed them against the following criteria (which incorporate the features set out in paragraph 4 above):

    - workability, including their impact on the funds' current systems;

    - fairness, in terms of vertical and horizontal equity, for entering and exiting investors, and in comparison to direct investment;

    - efficiency, including in relation to New Zealand's capital markets; and

    - investor compliance obligations – especially for KiwiSaver funds.

7. Set out below are our conclusions for each type of fund. A table in the attached annex summarises the different types of investment fund, and the Group's recommendation for each one.

Tax issues

8. Managed funds hold financial assets, listed New Zealand shares (with a very small holding of unlisted New Zealand shares), listed Australian shares, and other foreign shares.

9. The main issues with extending the taxation of capital gains to managed funds concerns how to tax New Zealand shares and Australian listed shares (collectively referred to as "Australasian shares") and real property. This is because PIEs currently do not pay tax on any gains from selling these assets.

10. The taxation of other kinds of assets held by managed funds would not be directly affected by a more comprehensive tax on capital gains. In particular, a fund's financial assets would continue to be taxed on a full accrual basis under the financial arrangement rules, while other foreign shares could continue to be taxed under the current FDR method (although the question arises as to whether FDR should be retained if we adopt a different method for Australasian shares).

KiwiSaver / MRPIEs

11. Multi-rate PIEs (MRPIEs) are the most common type of PIE. Nearly all KiwiSaver funds are MRPIEs. MRPIEs are subject to various restrictions, which ensure they are widely held and make passive investments. In particular, a PIE may not hold more than 20% of a company. This ensures that MRPIE status is restricted to managed funds.

12. MRPIE investors enter by investing in the MRPIE, and exit by withdrawing that investment. They do not typically sell their interests in the MRPIE (and cannot do

so with KiwiSaver). MRPIEs need to regularly value their investments, and hold liquid assets, in order to pay out investor transfers and withdrawals.

Tax treatment

13. Investment through a MRPIE is broadly taxed as if the investor held its share of the PIE's investments directly. However the MRPIE is responsible for paying the tax for investors not on a 0% rate (such as natural persons), meaning the investors do not need to file tax returns.

14. This is achieved by the PIE attributing all its income to its investors, in proportion to each investor's share of the PIE. The PIE then pays tax on the income attributable to each investor, at that investor's PIE tax rate. The PIE tax rate generally corresponds to an investor's marginal rate, although the top PIE tax rate is 28%, compared to a top marginal rate of 33%. The PIE passes on the cost of the tax payable for each investor to that particular investor, by redeeming some of that investor's units or reducing its distributions to the investor.

15. No tax is paid on any distributions by the MRPIE to the investor, or on any redemptions of the investor's units in the MRPIE.

Options

16. The Group considered 6 different possible options for extending the taxation of capital gains to Australasian shares held by KiwiSaver funds and other MRPIEs:

    - Option 1 - retain the status quo ie. exempt gains from selling New Zealand and Australian listed shares. However this would distort economic decision making by the PIE, benefit wealthier taxpayers the most, and is a poorly targeted incentive to save.

    - Option 2 – tax on a realisation basis and attribute gains to investors on look-through basis (similar to a partnership). However, after consultation with the managed funds industry, this not feasible for MRPIEs to implement from a systems perspective.

    - Option 3 – tax on an accrual basis (possibly with a discount). This method is the same as the current comparative value method in the Income Tax Act. This method taxes an investor on its total accrued economic income in respect of the shares each year. Under this method, the MRPIE's income (or loss) each year would be the difference between the opening value of its Australasian share investments for the year and the closing value of those investments. Any distributions received and any proceeds from selling shares during the year would be added to income. Any cost in acquiring new shares during the year, and any foreign tax paid by the investor, would be deducted.

- Option 4 – apply the Fair Dividend Rate (FDR) to Australasian shares. This would create difficult boundary issues with managed funds vs direct investors and listed vs unlisted companies, especially when the impact of imputation credits is taken into account. It is also forecast to cost the Government money, compared with the current taxation of Australasian shares.

- Option 5 – tax KiwiSaver / PIE funds directly on realised gains with no attribution to investors. However this would remove the current flow through tax treatment of PIE income.

17. We consider that options 1, 2, 4 and 5 are not practical options for MRPIEs. Accordingly, the Group prefers option 3 – taxation of Australasian shares on an accrual basis (possibly with a discount).

18. Option 3 raises an issue as to whether a fund should apply accrual tax treatment to its non-Australasian shares (instead of continuing to apply FDR), and if so, whether direct investors should also pay tax on their non-Australasian shares on a realised basis. In this regard, the following options are all viable in relation to non-Australasian shares:

- **Tax funds and direct investors under FDR (as currently)**. This would align the taxation of managed funds with direct investors, and would involve the least change to the current tax system.

- **Tax funds on an accrual basis and direct investors on a realisation basis**. This broadly aligns the taxation of both direct vs indirect investment, and Australasian vs non-Australasian shares.

- **Tax funds on an accrual basis and direct investors under FDR**. This would tax managed funds the same way on all their share investments. However it does create a different tax treatment for direct vs indirect investment in foreign shares.

19. The Group recommends that the Government undertake wider consultation, following publication of the Group's final report, in order to determine which of these is the best method for managed funds and direct investors.

Potential discount for accrual basis

20. Accrual taxation of managed funds does create a disadvantage compared to direct investment. This is because direct investors would be taxed on a realisation basis, and so would pay the tax on their gains later than funds on an accrual basis would. To remove this disadvantage, it might be desirable to tax the funds' accrued gains on Australasian shares (and non-Australasian shares, if direct shareholders are taxed on a realised basis) on a discounted basis. This amount of this discount should in theory depend on the time a fund held its investments for, and on the turnover of investors in that fund. However it would be complicated and confusing to calculate

a discount on a per fund basis. Therefore a single average discount rate would need to be set, which would apply to all funds.

21. However investment through a PIE already enjoys tax benefits compared to direct investment. The tax rate on income is 5% less for investors on a 33% marginal rate (and will be 5% less for other taxpayers who invest through KiwiSaver). Any losses made by a PIE will be cashed out, instead of carried forward and ring-fenced against other capital income. Further, investment through a PIE removes the compliance burden of direct investment. These advantages might be sufficient to counter-balance the disadvantage of accrual taxation, meaning a discount is not necessary.

22. [Group to decide on whether to apply a discount].

Listed PIEs that own shares

Introduction and tax treatment

23. Listed PIEs are subject to the same restrictions as MRPIEs in terms of their permissible investors and investments. Accordingly, listed PIEs are also essentially required to be widely held managed funds.

24. Investors in listed PIEs usually enter and exit by buying shares from other investors. However listed PIEs still hold liquid assets and regularly value their investments.

25. A listed PIE does not attribute income to investors and its tax liability is not determined by reference to the investor's PIE tax rates. Instead the listed PIE pays tax on its income at the flat company tax rate of 28%. Listed PIEs earn imputation credits and impute dividends like ordinary companies.

26. However no tax is paid by shareholders on unimputed dividends from a listed PIE, and most shareholders can choose whether or not to be taxed on an imputed dividend (and receive the benefit of the attached credits). This election allows taxpayers on a higher marginal rate to have their share of the listed PIE's income taxed at 28%, while taxpayers on a lower rate can have their share of the PIE's income taxed at their lower rate, by offsetting their excess imputation credits against other income.

Options

27. There are 2 viable options for applying a more comprehensive tax on capital gains to shares held by listed PIEs:

    - Use the same method as for MRPIEs; or

    - Tax the listed PIE on a realisation basis, like an ordinary company.

28. The Group recommends the first option – taxing the same way as an MRPIE. This would increase horizontal equity and fairness (by taxing the same kinds of income

the same way), and prevent any tax related distortions in an investor's choice of investment vehicle. It would also be easier for investors to understand.

29. In addition, company taxation results in temporary double taxation (or double deduction of losses). This would result in a worse tax outcome for MRPIEs than both direct investment and investment through a MRPIE. It also:

    - requires investors to file tax returns when they sell their units; and

    - results in the over-taxation of income from the PIEs non-Australasian shares (if they are taxed under FDR). This is because the shareholder would effectively be taxed on any gains over the FDR rate, either when the income was distributed to them as an unimputed dividend or when they sold their shares.

Taxation of PIEs that own property

30. Property owning PIEs are not a separate type of PIE, the way MRPIEs and listed PIEs are. Instead property owning PIEs are a MRPIE or a listed PIE that invests directly in commercial property. Most property PIEs are listed PIEs, although there are some MRPIEs that own commercial property. Property owning PIEs typically do not invest in other types of assets.

31. Property owning PIEs are currently taxed the same way as other listed PIEs or MRPIEs. The only difference is that property related losses are ring-fenced against income from property for MRPIEs that do not value daily.

32. The Group considered 5 options for applying a more comprehensive tax on capital gains to property owning PIEs:

    - Option 1 - full accrual taxation of the property PIE, and no taxation of the investor. This has the benefit of taxing property PIEs the same way as other PIEs. However it would result in the PIE having insufficient income to pay its tax liability in some circumstances. This creates practical difficulties for the PIE. Further, property PIEs invest into different types of assets to other managed funds, so they not as substitutable from an investor's perspective.

    - Option 2 - taxation of both the property PIE and the investor (as with an ordinary company). Under this option the current tax treatment of tax-sheltered distributions (ie. distributions of amounts untaxed at the PIE level) would continue for direct investors (but not managed fund investors), so that they would not be taxable on receipt by the investor. Instead they would reduce the cost base of the investor's interest in the PIE. Effectively therefore, any tax-sheltered dividends would be taken into account when the investor sold its interest in the PIE. Any other managed fund that invested in a property owning PIE under this option would still be taxed on an accrual basis, as with all their other New Zealand equity investments.

- Option 3 - realisation based taxation, but at the investor level only. This creates a significant compliance risk, as all the tax needs to be collected from the investors.

- Option 4 - realisation based taxation, but at the PIE level only. This results in significant under taxation of investors on their capital gains.

- Option 5 - for MRPIEs, taxation like a partnership for direct investors. Tax would be imposed on a realisation basis, both when the MRPIE sold property, and when an investor exited the MRPIE, either by way of redemption or sale. This option is unworkable for ordinary PIEs, but it should be workable for most property owning MRPIEs. This is because most property owning MRPIEs are closed (meaning the MRPIE does not issue or redeem units after its inception), and the MRPIE sells its properties infrequently. Any other managed funds that invested in a property owning PIE under this option would still be taxed on an accrual basis, as with all their other New Zealand equity investments.

33. The Group consider that Options 1, 3, 4 are not desirable. Accordingly, the Group recommends:

    - Option 2 for listed PIEs (realisation based taxation, like an ordinary company). This has the disadvantage of taxing a listed PIE differently from direct investment in respect of the sale of the property. In particular, it results in temporary double taxation when an investor sells its shares for a gain and the PIE then sells its property for a gain. However this double taxation can be reversed when the investor sells its shares. In addition, property PIEs are income stocks (meaning investors hold them for their steady income stream), and this option treats the income from the listed PIE in basically the same way as the income from a direct investment in property.

    - Option 5 for property MRPIEs, with an election to use option 2 in case option 5 is not feasible for the particular property MRPIE.

Superannuation funds

34. Superannuation funds are retirement savings vehicles that are not under the KiwiSaver regime. An investor's savings are locked into a superannuation fund until retirement age. It is possible for investors to switch superannuation funds. However they do not sell their superannuation entitlements to other investors. This means investors enter by investing in the fund, and exit by withdrawing that investment. Superannuation funds hold liquid assets and regularly value those assets.

35. Superannuation funds are taxed under the trust rules[45]. The trustee pays tax on the funds income. Widely held superannuation funds are taxed at the rate of 28%, instead of the usual 33% trust rate. Distributions to the investor and redemptions are not taxed.

225. There are two workable options for extending the taxation of capital gains to superannuation funds:

- Tax shares the way as for a MRPIE; or

- Tax shares on a realisation basis.

36. The Group recommends the first option – taxing the same way as for an MRPIE. This would increase horizontal equity and fairness (by taxing the same kinds of income the same way), and prevent any tax related distortions in an investor's choice of investment vehicle. It would also be easier for investors to understand.

37. However some superannuation funds have a low asset value (eg under $500,000), and private superannuation funds only have a single investor. Accrual taxation would result in significant compliance costs compared to the income derived by these types of funds. Accordingly we recommend that small superannuation funds (eg. with less than $5m in assets) be able to account for gains on their Australasian shares on a realisation basis.

Life insurance funds

38. Life insurance funds derive income both from issuing life insurance policies, and from investing the premiums on those policies. They invest in the same kinds of assets as other managed funds.

39. Investors can save through certain kinds of insurance policies. These savings-linked policies allow investors to benefit from the investment income earned by the life insurer. The policies are not sold between investors, but they can be cashed in for their surrender value. Most life insurers no longer have savings linked policies, but there are approximately 200,000 still on issue.

40. For tax purposes, life insurers split their investment income between their shareholders and their policyholders. The shareholders are taxed on their investment income under the ordinary company rules. The policyholders are taxed on their investment income at 28% (with the life insurance company paying this tax).

41. Life insurers with a policyholder base are in a similar position to other PIEs, in that they are a pooled investment vehicle. They also hold liquid securities, which they need to price regularly. For this reason we recommend that they return their income

[45] Superannuation funds can also elect to be taxed like a MRPIE. This chapter considers the tax treatment of superannuation funds that are not taxed as a MRPIE (as the tax treatment of MRPIE superannuation funds will be the same as other PIEs).

from shares on the same basis as MRPIEs. This will provide a consistent tax treatment across investment vehicles.

42. Life insurers with no policyholder base are basically the same as other companies. Accordingly, we recommend that they be taxed on their shares in the same way as an ordinary company.

Retirement savings

43. It is anticipated that if no further changes were made to the taxation of KiwiSaver investments, taxing more capital gains would impose additional tax obligations of approximately $15 million per annum across KiwiSaver members with annual income of less than $48,000 and approximately $45 million per annum across high income KiwiSaver members.

44. Therefore the Group has developed a package that would address the impact of taxing more capital gains on retirement savings for low and middle income KiwiSaver members. The package consists of the following two initiatives:

    - Remove the employer superannuation contribution tax (ESCT) on the employer's matching 3% contribution, for KiwiSaver members earning up to $48,000 per year.

    - Reduce the lower PIE rates (currently 10.5% and 17.5%) for KiwiSaver funds by five percentage points each (and consider ways to simplify the PIE tax rate schedule, which is somewhat complex).

45. The combined effect of this package would be a reduction in tax of about $215 million per annum across members earning less than $48,000. This would greatly exceed the increased tax obligations on KiwiSaver investments resulting from the taxation of more capital gains for low to middle income earners (of $15 million).

Investment restrictions

46. In the course of preparing this report, it has become apparent that managed funds are limited in the kinds of investment they can make.

47. Managed funds (including KiwiSaver) need to be able to both value their investments (in order to determine unit prices) and realise them easily (in order to satisfy redemptions and transfers). This pushes the managed fund industry into investing in listed shares rather than unlisted shares. In fact that the entire New Zealand managed fund industry holds only $500 million in unlisted shares, as against a total asset base of nearly $132 billion.

48. This heavy bias towards listed shares means that New Zealand's unlisted sector does not obtain funding from the managed fund sector. This constrains the growth of the unlisted sector, particularly in the SME market.

49. It also means that the managed fund sector (including KiwiSaver) does not typically invest in certain kinds of investments which would provide benefits to New Zealanders. This includes investments like venture capital, infrastructure, social housing and sustainable investment. This is because these types of investment typically are not liquid or easily valued.

50. The Group suggests the Government consider if there is a way to help managed funds (particularly KiwiSaver) make these kinds of investments. For example if sustainable investments could be packaged into a listed vehicle, then the managed funds would become able to invest into that vehicle.

	KiwiSaver / Multi-rate PIE (MRPIE)	Listed PIE (non-land)	Land owning PIE (listed and multi-rate)	Superannuation (defined contribution)	Life insurance
Key features	- Invest in shares and financial instruments, both in New Zealand and overseas - Do not invest directly in land (may invest in other funds that hold land) -Assets are liquid (large funds may hold a small portion of illiquid assets) - Regularly value their assets to price their units -Investors enter and exit by buying or redeeming units. Sale of units between investors is uncommon/not permitted - For KiwiSaver, investors cannot access their funds until retirement age, but may transfer their funds between providers	- Invest in the same kind of assets as MRPIEs - Do not typically redeem - Still regularly value their assets to price their units - Investors generally enter and exit by selling shares between themselves - Shares are regularly traded	- Invest primarily in commercial property, and (assume) hold for longer periods - Assets are illiquid - Do not redeem units. - Investors enter and exit by selling shares or units between themselves - Earn rent and capital gains - For accounting and valuation purposes, assets are often revalued to market, usually quarterly or annually - For multi-rate PIEs, trading is often restricted to windows around valuation	- Invest in the same kind of assets as MRPIEs - Investors enter by subscribing for units and exit by redeeming their units - Investors do not sell their units - Investors are locked into the fund until retirement age	- Invest in the same kind of assets as MRPIEs - Investors can save through savings-linked policies and profit participation policies - Allocate investment income between shareholder base and investor (policy holder) base - Policies are not traded, but can be cashed in for their surrender value - Value investments regularly to calculate policyholder entitlements - 6 out of 32 registered life insurers have a policyholder base
Current tax treatment	- Attribute income to investors and pay tax on the attributed income at an investor's prescribed investor rate (PIR) - Gains from Australasian shares are exempt - FDR on other shares	- Taxed like a company, except gains on Australasian shares are exempt, unimputed dividends are not taxed to shareholders, and shareholders can elect to be taxed on imputed dividends - FDR on non-Australasian shares	- Taxed as a MRPIE or listed PIE - The properties are typically held on capital account, so gains on them are not taxed	Taxed like a trust except all income is trustee income taxed a 28% for widely held funds (33% otherwise), and distributions are exempt - Gains on Australasian shares are taxed on realisation, except for passive tracker funds - FDR paid on non-	- Investment income divided between the shareholder base and the policyholder base - Shareholder base taxed like an ordinary company - Policyholder base taxed at 28% on its share of the investment income - All tax paid by the life insurer

				Australasian shares	
Options for taxing more capital gains	1. A full accrual basis (including foreign shares), possibly with a discount for Australasian shares. This also raises an issue as to whether direct investor should account for their non-Australasian shares on a full realisation basis (rather than FDR as currently) 2. A full FDR basis (including Australasian shares) 3. Accrual for Australasian shares (including unlisted NZ shares), and FDR for other shares - Under all options, income is attributed to investors as at present. PIE pays tax on income at investors' applicable PIRs. There is no tax for investor on any distributions, redemptions or sale gains	1. Tax the same as a MRPIE. Investors would not be taxed on redemptions, or sale gains. Dividends paid taxed to investors as currently 2. Tax the same as an ordinary company, so on a realisation basis with two levels of tax. Dividends paid taxed to investors as currently	1. Tax the same as an ordinary company, so on a realisation basis with two levels of tax. This can give rise to temporary double taxation (and double deductions) until a distribution is made and the shares are sold. There are options to reduce (but not eliminate) the time double tax applies for. For direct investors, the PIE would be allowed to distribute untaxed income, with the distribution reducing the investor's cost base 2.For MRPIE property PIEs, tax direct investors like a partnership - managed funds taxed on their interest in the property PIE the same way as for other shares under both options	1. Tax the same as a MRPIE 2. Tax the fund on a realisation basis - The investor would not be taxed on distributions or redemptions under either option	- Tax life insurers with a policy base the same way as MRPIEs - Tax life insurers with no policyholder base like ordinary companies
Group recommends	Option 3 - accrual for Australasian shares (including unlisted NZ shares). The following options are all viable for foreign shares. The Government should consult further on which of them is best for New Zealand: - tax funds on an accrual basis and direct investors on a realisation basis - tax funds on an accrual basis and investors under FDR - tax funds and investors under FDR.	Option 1 - tax the same as a MRPIE.	Option 1 for listed property PIEs. Option 2 for MRPIEs, with an election to use option 1 in case option 2 is not feasible	Tax the same as a MRPIE, with a de minimis exception to allow small funds to be taxed on realisation	- Tax life insurers with a policy base the same way as MRPIEs - Tax life insurers with no policyholder base like ordinary companies

Appendix D - International tax treatment

Introduction

1. The New Zealand managed fund industry is in a different position from that in most other countries for tax purposes, due to our PIE regime. However we have considered the tax treatment of the Australian fund industry for the purpose of comparison. We have also considered the tax treatment of property investment funds in different countries.

Australian tax treatment of funds

2. Australian taxpayers pay tax on their capital gains on a realised basis – including managed funds and superannuation funds.

Managed funds

3. Managed funds in Australia are generally taxed under the Australian trust rules. This means that the managed fund calculates its income as if it was an Australian resident. It then allocates that income to the existing investors that are presently entitled to it on the last day of the income year. The investors on that date return all this income themselves (even if they were not investors for part of the period) and pay tax at their own rates. Any non-taxable payments reduce the cost base of the investor's units.

4. The managed fund itself pays tax on any income to which no investor is presently entitled. In practice however managed funds generally distribute all their income, to make sure the tax liability is borne by the investors rather than the fund.

5. Investors also pay capital gains tax (CGT) on any gain they make from selling their units. This results in double tax in two circumstances:

    - Where an investor sells its units, there will be double tax on any income or realised capital gains earnt by the managed fund before the sale in that income year. This is because any realised capital gain will be reflected in the unit price, and so the investor will pay tax on it when they sell their units. The realised capital gain will also be attributed to the entering investor at the end of the income year by the fund, and so the entering investor will also pay tax on that gain.

    - If a unit trust were to retain any income, then there would be double tax on the retained income when an investor sold their units. However unit trusts generally distribute all their income, so this is not an issue in practice.

6. Australia also has a managed investment trust (MIT) tax regime. MITs are similar to PIEs, in that they must be widely held managed funds that invest in passive assets. MITs are generally taxed the same as other managed trusts, but they enjoy

some tax concessions compared with other managed funds. This includes a concessional 15% final withholding tax on payments to non-resident investors (other than in respect of interest, dividends and royalties) from Australian sources. They can also elect to be taxed on their assets under the capital gains tax regime (meaning their members benefit from the capital gains tax discount for assets held longer than 12 months). No Australian tax is payable on income from foreign sources. It is common for New Zealand managed funds to invest into Australian MITs.

7. One type of MIT, called an attributing managed investment trust (AMIT), is taxed in a more similar manner to MRPIEs (although all income is still attributed pro-rata to members at the end of year). AMITs are able to attribute their income and credits to their members each year on a full-flow through basis. Australian resident members pay tax on the amounts attributed to them (including any capital gains earned by the AMIT). The members are also subject to CGT when they sell their units in the AMIT. However any double tax that would otherwise arise is dealt with by adjusting the cost base of the member's units.

8. This works by increasing a member's cost base by the amount of income attributed to them for an income year, and reducing their cost base by the amount of income distributed to them in that income year. This way, any income attributed to the member but not distributed is added to the cost base of the member's units, while any distribution in excess of their attributed income is subtracted from their cost base. This is a key benefit for AMIT compared with other managed trusts, as it allows the AMIT to accumulate income without resulting in double tax when its investors sell their units. This method does however require the members to adjust the cost base of their units each year.

9. The Australian approach also gives rise to issues with unit pricing, for both MITs (including AMITs) and other unit trusts. This is because the tax in respect of income attributable to investors is paid by the investors who hold units at the end of the income year. Therefore if an investor sells their units to another investor the day before the end of the year (or one investor exits and another enters), the new investor will incur the tax on all the income earned during the year (even though it only held the units for a day).

10. This requires the fund manager to adjust unit prices to reflect the tax on the fund's income as it accrues during the year. We understand that this is difficult to do however, and so does not always occur.

Superannuation

11. Australian superannuation funds have their own tax regime. Employer contributions up to a prescribed annual limit are concessionally taxed at 15%, with contributions over the limit taxed at the employee's marginal rate. Employee contributions are not taxed.

12. Complying superannuation funds are taxed on their earnings during the accumulation phase at 15%, with capital gains generally taxed at 10%. Earnings from assets in complying funds (including capital gains from the sale of the assets) are tax-exempt if they support current pensions.

13. The taxation of benefit payments by an Australian superannuation fund is complex, and depends on several factors. The general rule is that a superannuation benefit paid to a person aged 60 and over as a superannuation lump sum or income stream benefit is not taxable, except to the extent it includes an amount that was not taxed in the superannuation fund (eg a public sector fund where the benefit includes an element not taxed in the fund). These untaxed amounts are also subject to a life-time $1.4m cap, below which they are taxed at 15% (rather than the member's marginal rate). There are no capital gains tax implications from receiving a superannuation fund benefit.

14. From this it can be seen that managed funds are generally subject to full Australian taxation, with no concessions for Australian resident investors (although MITs offer some concessions for non-resident investors). However the Australian superannuation fund industry has very generous tax concessions compared with direct investment.

International taxation of property investment funds

15. We have looked at the taxation of real-estate investment funds in Australia, Canada, South Africa, the UK and the US.

16. The majority of these regimes:

    - tax capital gains from selling properties on a realisation basis;
    - impose tax at both the shareholder and investor level in theory;
    - avoid double tax by in practice only taxing the investor provided the fund distributes all its income as earned (the United States also prevents double tax on retained realised gains as discussed below);
    - tax the fund on the amount of income it retains; and
    - tax the investor on all distributions they receive.

17. All the regimes tax the investors on any gains they make from selling their units in the fund.

18. In particular, the U.K. has a full tax exemption at the fund level (so retained gains are not taxed to the fund). However the fund must distribute at least 90% of its rental income in order to qualify for this tax treatment. Distributions of income are fully taxed, as are gains from selling units in the fund.

19. Australia and Canada have trust flow through regimes, which tax the investor on any income attributed to them, and the fund on any income not so attributed (with the result that funds generally distribute all their income). Both Australia and Canada allow for the distribution of untaxed income to the investor (meaning neither the fund nor the investor is taxed on receipt of the income). However they reduce the cost base of an investor's units by the amount of these distributions of untaxed income. Investors are also taxed on any gains they make from selling their units in the fund. The Australian tax treatment is set out in more detail in Appendix D.

20. The United States and South Africa have deductible dividend regimes, with the fund taxable on any amounts not distributed. The United States also prevents tax on undistributed realised gains by taxing the income to the fund, allowing the fund to declare the same amount of income to be taxable to its investors, the investors get a credit for the tax on the income paid by the fund, and the investors also increase the cost basis of their shares in the fund by the income they were attributed (equivalent to a NZ taxable bonus issue). South Africa does not tax any capital gains at the fund level, but it also denies various capital allowances in respect of the property. Distributions are fully taxed and investors are subject to tax on any gains from selling their units.