



Niels Campbell Partner

A guide to the new offshore portfolio investment rules

The Government enacted new tax rules late last year which will affect most New Zealand investors who hold interests in offshore companies and unit trusts from 1 April 2007.

This update provides a general summary of the new rules. They are complex and there are still a number of interpretation issues that need to be worked through. Bell Gully will send a series of updates focusing on more specific issues over the coming weeks and months.

Who the new rules will apply to

The new rules will apply to all New Zealand investors except individuals whose offshore portfolio costs NZ\$50,000 or less. Investors who are investing as the trustee of a trust will not be able to benefit from this exemption. This figure excludes the cost of offshore investments which are not subject to the new rules. These excluded investments are described further below.

Applying the new rules

Where the new rules apply, most New Zealand investors will be required to apply the fair dividend rate ("FDR") method to calculate income from their portfolio. Under the FDR method, investors are taxed each year on 5% of the market value of their offshore portfolio at the beginning of the tax

year (converted to New Zealand dollars) irrespective of the actual performance of their portfolio. In effect, the FDR method is more akin to a wealth tax than an income tax.

An alternative method, the comparative value method, is available for a limited class of investors. Individual and family trust investors can chose to be taxed on their actual realised and unrealised return (i.e. the net gain in value over the year, dividends received and net sale proceeds) if this is less than 5% of the opening market value of their portfolio. The comparative value method taxes both realised and unrealised capital gains.

Investments which are subject to the new rules must be pooled when applying the relevant method. An investor must chose to be taxed on 5% of opening market value or on the actual realised and unrealised gain each income year for their whole portfolio.

Significantly, under both methods, an investor cannot claim a deduction if the value of their portfolio declines in value over the year.

“Not all investments in offshore companies and unit trusts will be subject to the new rules.”



David Simcock Partner

Dividends are not taxed separately. Consequently, the FDR method would be beneficial and could result in an investor paying less tax than under the current rules if their dividend returns exceed 5%. The Government has indicated that foreign withholding tax deducted from dividends will still be available as a tax credit. However, there may be some unintended difficulties in claiming the credit based on the rules as they are currently drafted.

Under the FDR method, an investor who acquires and disposes of shares in the same income year (determined on a last-in-first-out basis) will be taxed on the lesser of:

- the actual gain derived on the sale; and
- 5% of the average cost of the shares.

The FDR method cannot be applied to certain investments with debt type characteristics. The Commissioner of Inland Revenue also has the power to identify specific investments to which the FDR method cannot be applied. Generally, the full net realised and unrealised gain on these investments will be taxed each year under the comparative value method.

Offshore investments excluded from the new rules

Not all investments in offshore companies and unit trusts will be subject to the new rules. The general exemption from the existing rules for investments in “grey-list” countries has been removed. However, the grey-list is still relevant in determining whether or not some of the exemptions from the new rules apply. The current grey-list countries are Australia, Canada, Germany, Japan, the UK, the USA, Norway and Spain.

The new rules will not apply to:

- most investments of greater than 10% in grey-list companies;
- interests in Australian companies and unit trusts that are both listed in Australia and required to maintain an Australian franking

account;

- units in Australian unit trusts that satisfy certain minimum investment turnover requirements if resident withholding tax is deducted from distributions to the investor by a New Zealand resident withholding tax proxy;
- shares in a grey-list company which are acquired by an employee under a share purchase agreement if the shares are subject to an eight year restriction on disposal which has not expired for a period of more than six months before the relevant income year.

There are also a number of exclusions with more prescriptive criteria that apply for a limited period of time. These include:

- shares in a grey-list company that was previously resident in New Zealand if the company continues to carry on business in New Zealand through a fixed establishment that incurs a minimum level of expenditure and engages a minimum number of employees/contractors;
- shares in a grey-list company that owns a New Zealand company that has been carrying on business in New Zealand for a period of 12 months or more and incurs a minimum level of expenditure and engages a minimum number of employees/contractors;
- shares in a grey-list company that, from 17 May 2006, is listed in New Zealand and has more than 20,000 New Zealand shareholders who own more than 50% of the company if more than half of the company’s assets by value are majority interests in other companies. This exempts GPG from the new rules for income years beginning before 1 April 2012.

As mentioned previously, the cost of these excluded investments is not taken into account in determining whether the cost of an investor’s portfolio exceeds NZ\$50,000.

“The new rules abolish the traditional distinction between income and capital.”



Joanne Hodge Partner

Portfolio investment entities

The new rules will not apply until 1 October 2007 to managed fund investors that elect to become portfolio investment entities (i.e. PIEs). Our newsletter in May 2006 outlined the PIE regime as it was proposed at that time. We will send a newsletter shortly summarising the updated PIE regime.

Investments in New Zealand equities, Australian equities meeting the above criteria, entities to which the more specific exceptions apply (for example, GPG) and real property in New Zealand or elsewhere, are not subject to the new rules. Capital gains in these investments can remain tax-free for many investors.

Comment

The FDR method imposes tax on a deemed return regardless of actual distributions received and foreign exchange fluctuations. Investors on the top marginal tax rate will be required to pay tax equal to 1.95% (i.e. 5% x 39%) of the value of offshore shares they hold at the beginning of the tax year.

The new rules abolish the traditional distinction between income and capital. An investor will be required to pay tax on deemed income from offshore share investments notwithstanding that they are held on capital account for long-term gain and regardless of whether gains have in fact been realised. The same rules will apply to revenue account investors.

Investors need to determine how the new rules will apply to their offshore investments before 1 April 2007. Investors who are currently provisional taxpayers will need to consider how the new rules will affect their provisional tax payments in the 2007/2008 income year.

If you did not hold on 1 April 2007 any of the investments which will be caught by the rules, you would not have had to pay tax on the FDR basis. On the other hand, if you sold your investments any time after 1 April 2007, you would have to pay tax on 5% of the full value of your holding on 1 April, even though you do not hold the investments for a full year. This means that if you are intending to sell investments which would be covered by the new rules, you should do so before 1 April this year.

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