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growing and protecting the wealth of New Zealanders

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Taxation of Foreign Superannuation
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Taxation of Foreign Superannuation

The Financial Services Council (**FSC**) is grateful for the opportunity to provide feedback on the Paper (**Paper**) published by Inland Revenue and Treasury Officials in July 2012, setting out a proposal for reforming the taxation of foreign superannuation in New Zealand. The FSC is supportive of the proposal to reform the tax treatment of foreign superannuation and the general approach adopted in the Paper.

The Paper proposes that all foreign superannuation schemes should be caught by a single regime that taxes a proportion of any lump sum payment from that scheme on distribution. The includable portion brought into the charge to tax increases over time at a rate that is apparently designed to reflect the accumulated benefit of deferring tax that would otherwise have been payable under the FIF regime (the **Inclusion Method**).

The FSC has the following comments on the Paper:

- The Inclusion Method has the merit of simplicity; however it is also likely to result in unpredictable and asymmetrical tax outcomes and is unlikely to encourage the repatriation of foreign superannuation savings. For these reasons we consider that the Inclusion Method should be the *default* rather than the *only* option for the taxation of foreign superannuation savings.
- Taxpayers should have the further option of electing:
    - taxation under the FIF regime; or
    - to be taxed only on the value accumulated in the scheme since the date of migration (after deducting all post residency contributions).
- Roll-over relief should apply to funds that are repatriated to New Zealand and placed in a locked-in scheme such as KiwiSaver.

The Inclusion Method should be the default option

As noted in Chapter 2 of the Paper, much of the complexity of the current regime comes from the need to properly identify the true nature of the foreign superannuation scheme and then accurately categorise its tax treatment under New Zealand law. Creating a single stand-alone regime for

"foreign superannuation schemes" that taxes investors in line with their receipt of proceeds from the scheme is a significant step towards improving clarity and simplicity of treatment for investment products of this nature.

While the inclusion regime has the merit of simplicity, it is quite different from the other investment taxation regimes currently imposed on New Zealand investors with offshore savings. Differences between these regimes produce anomalies that impact on the fairness of outcomes. Unfair outcomes are, in turn, likely to have a negative impact on compliance, the promotion of savings and the taxation of savings. For this reason the FSC submits that the Inclusion Method should be optional; migrating investors should be given the option of electing an alternative treatment that is more in line with the outcomes provided for under the existing rules.

For this reason the FSC favours providing taxpayers with the option of taxing the scheme under the FIF rules and providing taxpayers with a further option of being taxable on the increase in value (but only the increase in value) of their superannuation fund from the time the investor became a New Zealand resident (or ceased being a transitional resident).

Inclusion method taxes repatriated capital

The Inclusion Method brings the accrued capital value of the fund into the New Zealand tax net over time. As the inclusion rate ramps up, it necessarily ends up capturing the value that has accrued to the fund before the taxpayer migrated to New Zealand. The policy rationale for taxing this pre-migration value would appear to be that it is *quid pro quo* for the benefit of avoiding tax on the value (or increase in value) of the fund in each year the migrant is resident in New Zealand.

Whatever formula is used to calculate the inclusion rate, it can only ever be a rough proxy for the actual tax consequences that the investor might otherwise have been subject to under an alternative regime.

The formula used to calculate the increase in the inclusion rate must necessarily be an approximation – the assumptions set out in the Annex to the Paper suggest a deemed (taxable) rate of return of 5% (compounding) and an average domestic tax rate of 33%. Neither of these assumptions are likely to be true for any particular taxpayer, in any particular year and in relation to any particular scheme. This means it will be difficult for a taxpayer to accurately predict whether they will be better off leaving their foreign superannuation funds offshore or repatriating them to New Zealand.

Inclusion method will not encourage repatriation

An inclusion rate that increases over time, ought, other things being equal, to incentivise the migrant to transfer their superannuation savings to New Zealand sooner rather than later. In particular, a migrant might choose to transfer the funds within the first few years in order to capitalise on the proposed 0% inclusion rate or to secure the exemption available under the transitional residence rules. Unless, however, the migrant is certain to remain in New Zealand there is unlikely to be much of an incentive (and a diminishing incentive) for an investor to repatriate their superannuation under the proposal set out in the Paper. This is particularly the case if, as is usually the case, the foreign superannuation scheme is subject to a preferential tax regime in the country where it is established.

The Inclusion Method is therefore at risk of creating a tax-advantaged product (foreign superannuation savings) when compared to PIEs and investments that are taxable under our FIF regime and financial arrangements rules.

Taxing only the increase in value

Providing taxpayers with the option of being taxed under the FIF regime or only on the increase in value from the scheme (after deducting all post residency contributions) would improve fairness by placing the taxation of foreign superannuation schemes on a more equal footing with domestic investors. It would also encourage repatriation of foreign savings as it would protect the migrant from taxation on repatriation of capital. A model for taxing only the net gain since migration already exists under our financial arrangements rules.

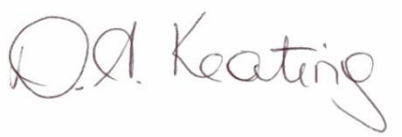
Migrants who are party to a financial arrangement are given a market value basis in their financial arrangement when they first become New Zealand residents and are required to recognise, as income, any untaxed gain on realisation (or on ceasing to be subject to the financial arrangements rules) through the base price adjustment mechanism.

If tax deferral is a concern such a regime could treat the resulting income as spread evenly over the intervening years and charge a deemed rate of interest based on the untaxed amounts in each year.[1]

Rollover relief for contributions to locked-in schemes

Migrants who transfer their funds out of a foreign superannuation scheme should not be exposed to an immediate charge to taxation when these funds (or an equivalent amount) are transferred into a New Zealand locked-in scheme such as KiwiSaver. Such an outcome would be contrary to the policy framework set out in the Paper which is designed to ensure migrants are not subject to a tax charge without having access to the underlying funds to meet the tax liability. It would also, as a policy matter, incentivise taxpayers to repatriate their funds to New Zealand if they were entitled to some form of rollover relief in relation to a lump-sum contribution to a locked–in scheme. The tax amount could be calculated at the time of repatriation but only become payable (without interest) once distributions were made from the scheme. The treatment would also address the uncertainty with whether migrants "derive" income at the time of transfer where they do not have a current entitlement to the transfer value.

Yours sincerely,



Deborah Keating
EXECUTIVE OFFICER

[1] If this was the case, however, the tax rate that should apply should be the taxpayer's marginal rate or portfolio investor rate in each intervening year.