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Our ref KPMG submission - Amending the FIF rules for migrants

27 January 2025

Dear Sir | Madam

KPMG submission – Effect of the FIF rules on immigration: proposals for amendments

We welcome the opportunity to comment on the officials' issues paper concerning proposed amendments to the FIF rules for migrants.

New Zealand's FIF regime plays a critical role in shaping the country's appeal as a destination for global talent and capital. Tax policy, as we have previously observed, is often a material factor in the decisions of individuals when determining where to live and invest. While New Zealand offers an enviable lifestyle, its current accrual based FIF regime is perceived by many as a financial barrier to residing here on a more permanent basis.

New Zealand's economic growth and global competitiveness depend on attracting and retaining individuals with the capital, skills, and connections necessary to drive innovation and opportunity. While the Government has taken positive action by refreshing immigration policies to better encourage talent to New Zealand, these initiatives will be ineffective unless supported by complementary tax settings. The current FIF regime undermines these efforts, discouraging global talent and capital from considering New Zealand as a viable long-term base. A realisation-based tax approach would better align tax policy with broader immigration and economic goals, creating a cohesive strategy to enhance New Zealand's global attractiveness.

We recognise that current political and economic constraints may mean that the ability to apply tax on a realisation basis may only initially be available to new migrants. However, we feel strongly that the election should be made available to other New Zealand tax residents., Further, if a phased approach was to be adopted to broaden the availability of these rules at a future date, that the proposed timing of this is communicated to taxpayers from the outset.

Expanding the availability of the realisation basis of taxation to all New Zealand tax residents supports the principles of equity and horizontal and vertical fairness upon which our tax regime is built. Such a change would send a strong signal to current and prospective New Zealanders that the country values their contributions and is committed to maintaining a broad base low tax rate environment that supports their success. A realisation-based taxation may even improve

compliance and trust in the system as it is an internationally accepted way of taxing assets, ultimately supporting long-term revenue goals.

Further, we believe that imposing tax on a realisation basis will not be a fiscal cost for the Government. This is because individuals who would not otherwise contribute to New Zealand in any material way, either financially or through the access to other opportunities and markets, will be residing in New Zealand, paying GST and income tax and applying their skills and experience to better New Zealand. We expect these benefits will far exceed the relatively small amount of tax we understand is currently collected from the current FIF regime.

In terms of specific design features, we discuss these in our detailed responses to the questions to submitters as set out in the **Appendix A** to this letter.

We also enclose at **Appendix B** our previous submission to David Carrigan dated 12th April 2024, in which we discuss the reasons why KPMG considers the FIF rules require reform.

Further information

Please do not hesitate to contact Rebecca Armour on 09 367 5926, Rebecca Simpson-Heine on 09 363 33479 or Robert Grignon on 09 304 5295, should you wish to discuss this submission in greater detail.

Yours Sincerely,

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Partner

Rebecca Simpson-Heine
Director

Robert Grignon
Director

APPENDIX A – RESPONSES TO QUESTIONS FOR SUBMITTERS

We make the following submissions in response to the questions for submitters posed in the officials' issues paper.

Chapter 3 – Scope

1. Do you agree the proposal should only apply to migrants?

As noted above, we appreciate that current political and economic constraints may mean that the ability to apply tax on a realisation basis is only initially available to migrants. We feel strongly, however, that the election should be made available to all New Zealand tax residents either immediately, or through a phased approach in the future.

Whilst the proposals are framed around making New Zealand more attractive to migrants, the tax settings should equally encourage those who already reside here to want to stay. In our experience there are many people already residing in New Zealand for whom the current settings are problematic. This includes migrants and New Zealanders who have previously spent time overseas, but also includes many New Zealanders who have built up their organisations and international networks from New Zealand, despite its geographical isolation. These people contribute a great deal to New Zealand, and in the absence of a material change to the FIF rules, we are at risk of losing these talented, entrepreneurial New Zealanders for the same reasons that global talent currently does not come to New Zealand. Accordingly, the tax regime should also work for them.

2. What do you think would be a good test for determining whether someone is eligible for having their FIF interests taxed on a realisation basis?

To the extent a broader scope for the application of the proposal is accepted, we consider that any individual (or trust) holding FIF interests which are taxable under the accrual regime at 1 April 2025 and going forward, should have the ability to elect into the regime for the tax year ended 31 March 2026 and future years.

Where a more limited scope is applied, we consider that at the time of becoming a New Zealand tax resident to whom the FIF rules apply it would be appropriate for an individual to have the ability to elect to apply the realisation basis of taxation.

In the case of a person who qualifies as a transitional resident, the election should be available in the income year in which they become a 'regular' tax resident. The issues paper suggests that the Government could apply the changes retrospectively from 1 April 2025. Ideally, while the election could apply for tax years from 1 April 2025, we consider that there is no reason that the ability to elect should not be available to individuals who became New Zealand tax resident at an earlier date. Further, we are aware there are many individuals currently present in New Zealand with transitional resident status, who may choose to leave New Zealand prior to their status expiring if the new rules are not made available to them. At a minimum, assuming the first wave of reforms are targeted at migrants only, we consider the election should also be able to be made

for anyone who ceases to be a transitional resident on or after 1 April 2025 (even if they are already tax resident in New Zealand).

Consideration should also be given to whether the election should be available for family trusts. It is very common for the types of persons targeted by these reforms to hold shares in trusts, typically for asset protection, as part of their estate and succession planning, etc. Limiting the proposals to shares held by natural persons may significantly undermine the effectiveness of the reforms and remain a real barrier to talented people moving to New Zealand. There is already precedence for treating trusts and natural persons similarly under the existing FIF rules, including their ability to elect to change between FDR and CV methods annually (which is not available to companies).

Assuming the initial round of reform will target migrants only, then rules would be required to determine which trusts are eligible to make the election. For example, this could be limited to trustees of a complying trust of which the principal settlor of the trust is a person eligible to make the election.

3. If you think some test based on the number of years spent as a non-resident is more appropriate, how many years do you think would be appropriate?

We consider the election should be available to anyone on becoming a New Zealand resident.

Restricting the rules to persons who also qualify as transitional residents is too restrictive. For example, a returning New Zealander who has been overseas for seven years and acquired shares in their overseas employer (say, an unlisted tech start-up) should be eligible. We see frequent examples of this situation. It would not be desirable to incentivise New Zealanders wanting to return home to remain non-resident for longer in the pursuit of the ability to better manage future tax obligations.

Further, there are also many examples of non-residents who visit New Zealand for a short period and later return to New Zealand on a long-term basis, particularly in cases of international assignments for multinational companies. Differentiating between the ability to apply an election to investments acquired prior to one period of residence but not another adds an unnecessary layer of complexity to the proposed election.

Accordingly, we also consider the ‘once in a lifetime’ rule applicable to transitional residency should not apply. The election should be available any time someone who was not a resident becomes a resident.

Officials may be concerned that without a minimum period of absence to qualify, there is an opportunity for people to take advantage of the rules by giving up tax residency and then returning to New Zealand. We do not consider this to be a major concern in practice, as ceasing to be a tax resident requires significantly more than a period of absence given the permanent place of abode test. Further, access to the election only impacts the timing of taxation and not the incidence of tax and accordingly in our view, there is limited scope for avoidance.

We also observe this is only a concern because it is proposed to restrict the election to migrants. If the election was open to all residents, as we strongly recommend is considered when the economic and political climate allows, then such integrity concerns would vanish.

4. Do you think the proposal should be limited to illiquid shares?

We consider that the proposal should apply to all shares.

Whilst the application of the FIF rules to "illiquid" shares poses additional problems (i.e. cash flow to pay the tax), their application to "liquid" shares is also a significant concern to migrants. We do not consider the extremely narrow scope favoured by officials would do much to make New Zealand a more attractive place to move, without, at a minimum, applying to *all* pre-arrival investments (although we also do not favour restricting the rules to pre-arrival investments).

5. Do you agree that being unlisted is a good proxy for being illiquid? If not, what is a better way to target illiquid shares?

We consider the election should be available for all shares, in which case targeting "illiquid" shares would not be a concern. We note that contractual barriers can restrict liquidity regardless of whether shares are listed or unlisted.

6. Do you agree the proposal should only apply to investments acquired before migration (unless the migrant would otherwise suffer double taxation on any gain from sale)?

We consider the proposal should apply to both pre- and post-arrival investments where an eligible person elects to apply the realisation method.

The proposal to restrict the rules to pre-migration investments is too narrow and, in our view, will continue to be an impediment to people wanting to move to New Zealand. Investments are not static nor finite, particularly amongst the types of migrants most impacted by the current rules who are discouraged from relocating to New Zealand. For example, venture capitalists and angel investors will continually be looking to develop and nurture new opportunities. If the current FIF rules will apply to all new investments made after becoming New Zealand residents, we suspect in many cases the limited changes proposed won't be compelling enough for them to commit to moving here (or remaining beyond their transitional residence period).

This would also be an issue, for example, for returning New Zealanders who may have acquired unvested options or shares in foreign employers. If shares are ultimately acquired post return to New Zealand, in our view those should also be eligible for the realisation method notwithstanding the fully vested shares are not acquired until after becoming resident.

7. Do you have any views or experience whether US citizens are entitled to a credit against their US taxes for New Zealand tax imposed under the FIF regime?

We are aware of conflicting views on this issue. For example, while some advisors suggest FIF tax may be fully creditable in the US, others are of the view that it is only potentially creditable against taxable dividends but not against capital gains taxes on realisation (or potentially vice versa).

Given our view that the regime should be available for post-arrival investments for all migrants (not only those who remain subject to double taxation), we do not see it as necessary to confirm the US position. However, if a distinction is to be drawn in the rules, then we suggest Inland

Revenue should seek definitive guidance on this, e.g. by liaising with appropriate counterparties at the Internal Revenue Service.

8. Do you agree that people who would otherwise suffer double taxation on their foreign investments even after becoming a New Zealand resident should be able to have all their foreign share investments taxed on a realisation basis?

As above, we consider the rules should be available for pre- and post-arrival investments, regardless of whether a person might otherwise suffer double taxation on the foreign investments.

If such a distinction is to be drawn, we note there may be several challenges in defining the scope. We understand this issue has generally been raised with US citizens in mind. However, the issue could apply more broadly. For example:

- A person in a non-DTA country might remain tax resident in that country under their domestic laws, at least for a period of time (e.g., if they maintain the equivalent of a permanent place of abode in the other country or spend a significant number of days in that other country). Does this mean that such a person would be eligible for the regime in the year they become a New Zealand tax resident if they happen to also be resident in the other country at the time, notwithstanding they might cease to be resident in that other country at some point?

- A person has a portfolio interest in a land-rich company incorporated in a DTA jurisdiction and is taxed in that jurisdiction on a realisation basis on the disposal of the shares. Should this person be able to opt into the realisation based FIF method for those shares only (if they have otherwise already opted into the realisation regime for pre-arrival investments)?

The rules would also need to address what would occur if a US citizen (or green card holder) ceases to be subject to US tax (e.g. through formal expatriation). These issues would not need to be dealt with if the regime isn't limited to those persons subject to double taxation.

9. Do you agree that any rule targeted at avoiding double taxation should be subject to the existence of a minimum foreign tax rate? If so, do you agree that 15% is a reasonable minimum rate? If not, what rate would you suggest?

This would be a non-issue under our preferred approach as the regime should be available for post-migration investments regardless of whether the person is subject to tax in another jurisdiction.

In the event the rules are restricted to those persons subject to double taxation, we do not think the rate in the other jurisdiction matters. We struggle to see the relevance of this, given it has no impact on the tax that would be collected in New Zealand (it simply impacts the potential double taxation faced in the other country, subject to any foreign tax credits that may be available there for the NZ tax).

It is worth observing here that opting into the realisation method is not, in our view, about optimising the New Zealand tax position. While tax may be deferred it will ultimately be paid (assuming an "exit tax" is also implemented). It is more about aligning tax payment obligations

with when a person thinks they may be able to best meet those tax obligations, e.g. when there is sufficient liquidity to pay the tax.

Chapter 4 – Methods

10. Do you think that removing the 10% threshold for accessing the attributable FIF income method is a viable solution? If so, should it apply to everyone or just migrants and to liquid investments as well as illiquid ones?

We support removing the 10% threshold, for everyone (not only migrants) and for both liquid and illiquid investments.

In practice, it may be that this is of limited use to many investors given the requirements to have detailed information to apply the active income test and to calculate FIF income if the company does not satisfy the test. However, for investors who are able to access the appropriate information, we do not see any principled reason to retain the 10% threshold.

Chapter 5 – Revenue account method

11. Do you agree the revenue account method should be available in relation to all investments owned by migrants facing double taxation at an effective tax rate of 15% or higher?

See previous comments. Our preferred approach, for an initial phase of reforms targeted at migrants, is for the revenue account method to be available for all migrants, in relation to all FIF investments (liquid or illiquid and whether acquired pre- or post-migration), regardless of whether the migrant is subject to double taxation.

We consider that the availability of a revenue account approach will better align the taxing point with the realisation of any gain to support the workability of the tax system.

Too often we see situations where tax obligations are arising to individuals in New Zealand in connection with their FIF interests, where (a) there is no actual economic gain (for example where the market value of the investments is below the level of original cost but on an annual assessment basis a gain has been made and (b) where there is no cashflow to support the tax obligation due to the illiquidity of the investment.

12. Do you agree that this method should be elective?

Yes.

13. Do you agree that the method should apply on a portfolio basis?

Generally, we agree that the method should apply on a portfolio basis, however we consider there should be the option to apply the current FIF rules to certain investments – i.e. to maintain a “realised based” portfolio and a separate portfolio applying existing rules. Potentially, an election could be made to apply the existing rules to listed shares only, with all unlisted shares being held in the “realisation based” portfolio.

We consider this flexibility would allow investors the opportunity to better make decisions about when they expect to have sufficient liquidity to meet their tax obligations. Again, we consider this is a principled approach to enable taxpayers to best consider when cashflow is likely to be available to pay the tax.

14. Do you think that electing into this method should be irreversible?

We do consider that there is benefit in making the election irreversible, at least with respect to investments held in the portfolio to which the rules apply (if it is possible to apply different rules to different portfolios). The lack of ability to move between the calculations will reduce the risk of a taxpayer to manipulate a tax outcome based on a more favourable approach and will ensure that the

15. Do you agree that a migrant who would no longer suffer double taxation should align how they treat their foreign shares with migrants who were not subject to double taxation?

For the reasons previously discussed, we consider the method should be available regardless of whether they are subject to double taxation.

We appreciate this wider scope may exacerbate the inequity (real or perceived) between the tax settings for ordinary residents and those who have migrated to New Zealand. In our view this supports considering further reform to open the rules to all New Zealanders, rather than narrowing the "exception" for migrants (to minimise political fallout) which will ultimately undermine the objectives of the reform by not going far enough to make New Zealand attractive to migrants.

16. Do you agree with the suggested approach to deem a disposal for market value in this case?

N/A

17. Do you think a lower tax rate or discount would be appropriate under the revenue account method?

We agree that a discounted tax rate would be appropriate under the revenue account.

18. Can you explain what tax rate or rate of discount would be appropriate and why?

From a high-level survey of OECD jurisdictions, virtually all regimes appear to apply lower tax rates to capital gains, typically not exceeding 20-25%. Given the objective of attracting migrants to New Zealand, we consider it is extremely important to be internationally competitive in terms of applicable rates, while not engaging in a race to the bottom. Implementing a realisation method but taxing gains at 39% is, in our view, highly unlikely to achieve the objectives of the proposed reform.

Whilst any rate suggested is somewhat arbitrary, we consider a 50% CGT discount approach, similar to Australia, to be a reasonable option. Consideration should also be given as to whether

a distinction should be made between short-term and long-term gains (e.g. applying the 50% discount only to shares held for at least 12 months).

Whilst these discounted rates may apply to disposals, consideration should also be given to whether dividends would enjoy the same benefit. There is some international precedent for lower rates applying (e.g. the US taxes "qualifying dividends" at lower capital gains tax rates, whilst "nonqualified dividends" are taxed at ordinary rates). We consider that the discounted rate in a New Zealand context for realisation-based taxation should solely apply to the investment disposal and not any dividend income for reasons of equity.

19. Do you think it would be better to establish the opening value of shares for New Zealand tax purposes with a valuation requirement, or to use a pro rata time-based apportionment?

We would generally expect the cost base in qualifying shares to be reset to market value as at the time the person becomes a resident, consistent with the deemed disposal and reacquisition rules in the existing FIF regime, without an explicit valuation requirement. This expectation is on the proviso that sufficiently robust information is available to establish market value.

A number of these design features were considered in detail by the 2019 Tax Working Group (TWG) as part of their considerations for implementing a capital gains tax regime. We suggest officials' review and consider the views expressed by the TWG as to such issues.

20. Do you think we should allow other cost methods in addition to, or in place of, FIFO? If so, what other methods would you suggest and why?

As above, we suggest referring to the CGT design considerations and recommendations set out by the TWG as applicable to a realisation-based regime applying to share disposals.

We understand that it is generally optional in the US to apply either the FIFO or LIFO method for capital gains tax purposes. To the extent the FIF reforms are being designed in part to ameliorate US double taxation concerns, this suggests similar optionality should be available in New Zealand as otherwise there could be large mismatches between taxable gains arising in the two jurisdictions.

21. What information do you think taxpayers who elect to apply the revenue account method should disclose?

We are generally supportive of New Zealand's self-assessment regime approach. This would suggest minimal disclosure is required as part of the taxpayers' return, however detailed records must be maintained to support the positions taken, to be made available to Inland Revenue on request.

In the event the regime is restricted to pre-migration investments only, then it may be slightly less onerous to require taxpayers to provide details on the full portfolio as it enters the New Zealand tax net (including market values for all applicable investments for purposes of establishing cost base). However, to the extent the rules also apply to post-migration investments, we consider taxpayers should not be required to profile full portfolio details on an annual basis.

22. Do you agree that an exit tax should be implemented alongside the revenue account method to shore up the integrity of the regime?

As previously discussed, one of the significant justifications for this reform is allowing taxpayers to manage liquidity concerns by (generally) deferring payment of tax until a gain has been realised which can be used to pay the tax liability. This is about aligning tax obligations to match cash flows, not escaping tax entirely. Without an ongoing requirement to return income upon a realisation event, we consider there is a risk that a person who ultimately leaves New Zealand prior to realising investments (and who could potentially return later) might fully escape taxation – which, aside from revenue concerns, would potentially introduced inequity into the tax regime, particularly as against New Zealand residents who are ineligible to apply the realisation regime (and are themselves subject to deemed disposals on migration under existing regimes, e.g. the FIF rules and the financial arrangements rules).

From a high-level survey of comparable jurisdictions, it appears that "exit taxes" of this nature are not uncommon, so may not be viewed as unacceptable by most (or at least some) migrants. There are some challenges with the introduction of an exit tax which we recognise, in particular, the need to ensure that in addressing one hurdle to migration (the timing of FIF income recognition) it could be replaced with another to the extent that there is a tax liability upon a deemed disposal event. As such, there are a number of additional design considerations which would need to be taken into account. For example, whether the tax would be immediately payable or whether this could be deferred until the shares are sold. Canada is a jurisdiction, by way of example, where we understand taxpayers can elect either approach. The ability to defer payment until realisation may be perceived as more "fair", as otherwise the same issues around liquidity and the ability to pay the tax arising on an unrealised basis (due to the deemed sale on leaving NZ) may otherwise make the regime unattractive.

Ultimately, if choosing to defer the taxing event until the point of realisation, the tax is not an "exit tax" in the traditional sense and instead simply recognises the individual was present in New Zealand during the time at which some of the gains were generated. In these circumstances, the tax liability could be determined by reference to either a pro-rata taxation of the gain based on temporal analysis (e.g. the individual was tax resident of New Zealand for 4years of a 10-year holding period, therefore ⅖ of the gain is taxable in NZ) or by reference to actual gain realised over period in NZ (subject to availability of market information). Alternatively, measures similar to those already in place in respect of trust distributions to non-resident beneficiaries could be introduced whereby realised gains derived by a taxpayer who has re-established their New Zealand tax residency within five years of becoming a non-resident may be subject to tax.

Considerations of compliance and enforcement will need to be managed in situations where a person leaves NZ and elects to defer paying tax until shares are ultimately sold, potentially many years after they have severed all connections with NZ. It is also acknowledged that New Zealand may only have a secondary taxing right over some gains depending on the jurisdiction in which the taxpayer resides at the time of the realisation event. However, we expect the reform of the FIF rules to result in a greater number of taxpayers who choose to reside in New Zealand on a more permanent basis and therefore, the tax base should broaden despite this.

23. Do you agree that transfers on death or under relationship property procedures generally should not constitute a disposal event?

We agree that transfers on death or under relationship property procedures generally should not constitute a disposal event. However, consideration would need to be given to how the rules are designed.

For example, in the case of death, should there be full relief and a step up in cost base for the beneficiary who inherits the shares? Should a New Zealand resident beneficiary be required to apply the existing FIF rules going forward or do they also "inherit" the ability to apply the realisation method to these shares? The latter query supports the submission above that the rules and ability to elect into a realisation basis of taxation will work better when it is broadly available rather than limited to a narrow group.

If the case of relationship property settlements, a "rollover relief" approach should apply, such that the recipient inherits the transferor's historical cost base. We appreciate that this may require some further consideration to address situations where for example the transferee is not otherwise eligible to apply to the realisation-based method.

Consideration should also be given to other events where "rollover relief" may be appropriate such as corporate demergers.

24. Do you agree that transfers on death or under relationship property procedures should constitute a disposal event if the transferee is a non-resident?

We consider there are good policy arguments for either approach, and potentially different approaches should be taken in the case of death versus relationship property settlements.

A deemed disposal on death could be viewed as a quasi "death tax" or inheritance tax, which is generally not a feature of New Zealand's tax system (with some exceptions). On the other hand, a full exemption could operate to mean the gains are never taxed; this could also create a behavioural incentive to hold shares until death to avoid taxation.

These issues are finely balanced and we think warrant further consideration.

25. Do you agree that loss on sale from investments taxed under the revenue account method should only be allowed to be used against other FIF income arising under this method?

We strongly agree that losses under the revenue account method should be available to offset FIF income arising under this method.

26. Do you agree that loss on sale from investments taxed under the revenue account method should be able to be carried forward into future years?

We also strongly agree that unused losses should be able to be carried forward to offset future gains under this method (but ring-fenced so as to only be available to offset FIF gains under the realisation method).

The ability to claim a loss on disposal on a realisation basis (when a genuine economic loss has been realised), and offset this against gains, is another significant design feature we consider necessary to make the regime appealing to migrants. The approach to losses under the existing

FIF rules is another key aspect of the rules which, in our experience, is surprising and highly unwelcome by migrants, who generally come from jurisdictions where offsetting losses against gains is standard and uncontroversial.

Chapter 6 – Deferral method

27. Do you think the deferral method is a viable solution to the problems identified in Chapter 2?

We consider that the deferral method adds a layer of complexity and cost to the taxpayer and as such, in many cases it is unlikely to be a solution to the existing issues with the FIF regime. We would however support the deferral method as an additional option, in addition to implementing the realisation-based approach and eliminating the 10% threshold to apply the attributable FIF income method.

28. Do you think that the deferral method could resolve the double taxation issue faced by some migrants?

Given the uncertainty regarding the US granting foreign tax credits, it is unclear to us whether the deferral method could improve the position. There are separate considerations as to what might be creditable against US tax on dividends and against US tax on realised gains. It is proposed in the issues paper that dividends would be taxed in NZ on receipt, in addition to the deferred FDR tax being payable on sale of the shares. This is likely to better align with the tax treatment in the US, so we suspect may improve the US foreign tax credit position (although the unusual method of calculating the tax could potentially still be problematic, as could the overlay of a use of money interest component and the ability for an individual to claim an associated tax credit).

29. If you do not favour the deferral method, can you explain why and what would be a better solution?

N/A

30. Do you think a formula for calculating actual gains would be a viable alternative to using a schedule?

We consider having the option to apply a formula method to calculate actual gains would be welcome, alongside the option to apply the schedule method. The schedule method effectively still imputes a 5% annual return, but in many instances a person's gain may be lower or they may have made a loss. Allowing the option of calculating the actual gain/loss would be welcome as an alternative.

Assuming dividends would still be taxable on receipt and the formula would only be taxing gains, we query whether having an interest charge is necessary as there is effectively no deferral (other than as compared to the ordinary FIF rules). Including an interest charge introduces a lot of complexity into the formula and may make this alternative less attractive, especially as it is imposing interest on a deemed gain where the taxing point has not yet occurred. Further, taxpayers may not be entitled to claim a tax credit for any interest charges incurred.

31. If the deferral method was adopted, do you agree with the proposed treatment of dividends set out above? If not, what treatment would you suggest and why?

We agree with the proposal to tax dividends as received. While potentially taxpayer friendly, it's unclear to us why dividends would also be subject to the schedular method where only a portion of the dividend is taxed depending on the length of time the shares are held. The dividend represents a real, present and quantifiable economic gain. The corresponding impact on the share price would be factored into the FDR calculations such that the FDR deferral should largely be taxing realised capital gains only.

32. Do you agree that the deferral method should be elective?

Yes.

33. Do you think that the deferral method should be available to everyone?

Yes. In principle, we do not see why this method should not also be made available to ordinary New Zealand residents. As observed in the issues paper, this may be particularly attractive in relation to illiquid investments where cash flow for paying tax under the existing rules is problematic.

34. Do you think the decision to elect into the deferral method should be reversible?

We consider this method should be available on a portfolio basis, whereby a person elects to hold specific investments in a deferral method portfolio (which is irreversible) but can apply other eligible FIF methods to other investments. This would give taxpayers more flexibility to assess their cash flows and liquidity for meeting their tax obligations.

35. What information do you think individuals who elect to apply the deferral method should have to disclose?

We agree that the election to apply the deferral method should have to be explicitly notified to Inland Revenue.

Assuming our previous recommendation to allow for separate portfolios is adopted (for example, a person can have both a deferral method portfolio and an FDR/CV portfolio), then notification of the specific investments for which the election is being made should be provided, to ensure the schedule method based on years of ownership could be properly applied.

APPENDIX B – PREVIOUS KPMG SUBMISSION ON NEED FOR FIF REFORM

As enclosed.

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David Carrigan
Deputy Commissioner, Policy & Regulator
Inland Revenue Department

Our ref

12 April 2024

Dear David

Taxation of offshore investments

Background and executive summary

In our dealings with clients, a constant area of frustration is New Zealand's outbound taxation settings, specifically the current foreign investment fund ("FIF") rules and their application to portfolio (i.e., less than 10%) shareholdings in foreign companies.

In our experience, these outbound tax settings can create a financial barrier to highly-skilled expatriate New Zealanders returning, and new migrants relocating, to New Zealand. For those individuals already here and holding interests in foreign companies, it can lead to them leaving, or looking to leave New Zealand. Many will have acquired these FIF investments while working overseas and will have established a connection to the company through either employment or other relationships, e.g., as founders, funders or providing mentorship or management expertise.

While some shareholdings will be significant, in most cases, these will be (or become, over time) portfolio investments, meaning the applicable FIF income calculation method will be on a deemed income basis – i.e., the Cost, Fair Dividend or Comparative Value Rate methods. It is not realistic, or reasonable, to expect these investments to be divested to avoid FIF taxation.

The concerns arise because:

- The available income calculation methods under the FIF rules impose tax on an unrealised basis – that is, without reference to cash-flows, such as dividends or proceeds from disposal.
- Current tax settings can result in cash tax obligations arising where there is no income generated at all over the life of an investment due to the failure of the entity.
- There is potential for double taxation, for example, if the foreign jurisdiction is able to exercise taxing rights at the time the investment is realised. The United States is one jurisdiction where this issue can arise, due to its citizenship basis of taxation, but this can also arise where there is no Double Tax Agreement in place.
- For private companies the tax calculations may require independent valuations, which can impose significant compliance costs and, in some cases, may not be possible at all. Even when valuations are available, they are typically for a specific purpose (e.g., capital raising)

meaning they are unlikely to be fit for purpose. They can be highly variable and volatile, and if relied upon for tax calculation purposes can result in significant tax liabilities that have no real basis.

- The investments can have little or no liquidity, for example because there is no active market for trading the shares, which is common in a "start-up" context. Or there may be an inability to dispose of shares due to the position of the shareholder – e.g., a divestment by a founder or CEO will have a market impact.

As you will appreciate, there is considerable international demand and competition for the individuals most impacted by these rules, including from Australia. The Government has publicly stated that New Zealand is "open for business" and is looking to actively attract investment and source skills to improve productivity. Those adversely impacted by the FIF rules are the very people with the capital, international networks and entrepreneurial skills that the Government is looking to attract and keep in New Zealand.

In discussions with impacted clients, there is a strong desire to contribute to New Zealand, including through the tax system (that is, they would prefer to pay tax in New Zealand). However, the current FIF methods for calculating taxable income from these investments are overly complicated and inequitable, for the reasons outlined above.

Our proposal is a simple new elective FIF option whereby individuals holding portfolio shareholdings in foreign companies can elect to pay tax on distributions received and any gain (or loss) made on realisation. This would effectively put these investments on revenue account, addressing what we understand was a key concern that underscored the FIF reforms in 2007 – the perceived under-taxation of offshore shares investments.

Our detailed analysis is contained below.

Rationale for FIF rules

We understand that historically, the FIF rules were introduced with an anti-avoidance purpose, to ensure that the domestic tax base was protected from arrangements which could avoid or defer the taxation of income in New Zealand, including through the accumulation of income in offshore companies.

In 2007, changes were made to address perceived under-taxation of certain offshore equity investments. The Commentary to the Taxation (Annual Rates, Savings Investment, and Miscellaneous Provisions) Bill notes:

The current tax rules for offshore portfolio investment in shares favours investment in eight so-called "grey list" countries (Australia, Canada, Germany, Japan, Norway, Spain, the United Kingdom and United States). Investments in companies resident in these countries are taxed only on dividends if they are held on capital account (which is likely to be the case for most individuals). Dividend-only taxation has become, in many instances, an inappropriate tax base because many foreign companies have a policy of paying low or no dividends. The investor can still, however, derive an economic gain from the investment via an increase in the share price. It is therefore quite easy at present to achieve a low tax or no tax result for direct portfolio investment in shares outside New Zealand. Furthermore, dividend paying and non-paying

offshore investments are often substitutable. This can leave higher income or more sophisticated taxpayers with significant ability to minimise their tax burden by investing offshore.

The objective of the 2007 reforms was to create more consistent and fair tax rules for offshore portfolio investment, including *"attempt[ing] to levy a reasonable level of tax on offshore share investments*".

We note the passage of these FIF reforms was not straightforward, with the Fair Dividend Rate ("FDR") and related methods, replacing the original proposals in the amending Tax Bill. However, we note the overriding policy intention was unchanged.

At the same time, there were a number of exclusions introduced to the (then) new FIF rules, including for offshore shares acquired through participation in employee share schemes, where there are restrictions on disposal. Therefore, it was clearly contemplated that FIF taxation may not be suitable in certain circumstances. Further, changes introduced to the taxation of foreign superannuation policies with effect from 1 April 2014 (previously solely taxed under the FIF regime), to tax these on a withdrawal basis, demonstrates that the application of a tailored regime for individuals who acquired offshore interests whilst non-resident is both acceptable and appropriate.

Current FIF calculation methods

In summary, for portfolio investments (that is, less than 10% shareholdings) in foreign companies, the current available FIF income calculation methods are:

- The Fair Dividend Rate ("FDR") which calculates taxable income at 5 percent of the opening market value of the investment at the start of their income year (e.g., 1 April for standard balance date taxpayers). Intra-period transactions (other than shares purchased after the start of the income year and sold before year end), distributions and disposals are ignored for tax purposes.

- The Comparative Value ("CV") which calculates taxable income based on the net movement in the share value (both realised and unrealised) during the income year and distributions received. Losses arising under the CV method are capped at nil, other than in the case of "non-ordinary shares." We note that the application of the CV method (in cases other than for "non-ordinary shares") is limited to individuals and family trusts and there is an accompanying consistency requirement. This means that, if selected, it needs to be applied to all offshore share investments held during an income year.

- The "Cost" method which is a variant of the FDR that applies in the absence of a market value for the underlying security. As a result, the Cost method constructs a starting "opening value" which is increased by 5% in each subsequent year (with the ability to reset the opening value in the 5th year). The complexity that arises with the Cost method is that the starting opening value may need to be set via reference to an independent valuation; it is not necessarily the cost of the investment to the holder, as the name of the method would suggest.

- The deemed rate of return ("DRR") which pre-dates the 2007 FIF reforms and, in our experience, is not generally used.

For completeness, we note that for shareholdings of 10% or greater (that are not interests in a Controlled Foreign Company), there is the option to apply the attributable FIF method. This method (which is based on CFC concepts) requires attribution of underlying income, in proportion to the person's shareholding, if the FIF is not an "active" business. Distributions are also taxable in certain circumstances (e.g., where the recipient is not a company) and the capital/revenue distinction needs to be considered on disposal of the shares. We raise the attributable FIF method as it more closely matches taxation of the shareholder, other than in the case of passive offshore investments where there is deemed attribution, to when there are actual cash-flow events. This method also requires the shareholders to have detailed financial information about the company, to apply the relevant calculations to establish whether the business is active.

The other features of the current FIF rules which are relevant for the purpose of this analysis are:

- The requirement to apply the chosen FIF income calculation method unless a change is specifically allowed (typically, this is when information to apply the existing method is either no longer available, or information becomes available to apply a different method). The exception is the ability for individuals and family trusts to switch between the FDR and CV methods, between income years, provided the chosen method is applied to all eligible assets within a portfolio.

- A foreign tax credit may be available where taxes have been withheld on distributions received from attributing FIF interests. A foreign tax credit will generally not be allowed in relation to taxes paid (if any) in foreign jurisdictions on realisation gains on those investments. This is notwithstanding that the FIF methods will generally tax some capital appreciation.

- Holders of FIF interests may also be required to complete a separate FIF disclosure where the investments are held in non-treaty countries or certain calculation methods are applied.

Practical issues with applying the FIF methods for portfolio share investments

In complying with the current tax obligations under the current FIF regime settings there are a number of practical implications for taxpayers.

Double taxation

A significant challenge that we regularly see in practice is the potential for double taxation when an investment is subject to tax in New Zealand under the FIF regime but is also subject to tax in another jurisdiction under a capital gains tax. This is particularly problematic for citizens of the United States who are subject to US tax on their world-wide income (regardless of their tax residence status).

Taxation of deemed income or unrealised returns is not a common feature of other tax regimes where income or capital gains taxes are imposed on a realised basis. So, a person can pay tax in

New Zealand on a deemed income/unrealised basis, under the FIF rules, yet have no ability to claim a tax credit in another jurisdiction as there has been no disposal to create a taxing event.

At the point of disposal, a taxing event arises in the foreign jurisdiction however there is ambiguity as to the availability of a tax credit for the tax paid in New Zealand on an accruals basis.

Similarly, when the shares are disposed of, New Zealand would not allow a foreign tax credit to be claimed against the FIF income for capital gains tax paid on US shares (to the extent that the US has the primary taxing right on the disposal income) even though, in our view, the FIF rules will have taxed some of the capital appreciation in advance.

Taxation in the absence of an economic return

As noted earlier, a key concern for clients is each of the current FIF income calculation methods calculating income with reference to either a deemed rate of return or unrealised investment returns (gains which are largely on “paper” and may never materialise). This is particularly of concern for those who hold investments in companies that are in the startup phase where the ultimate return, if any, will be uncertain.

FIF investments can often be high risk and will fail regularly. When a loss is realised, there is no mechanism available to obtain a refund of taxes paid over the life of the taxpayer’s shareholding under the FIF rules. This is because the FIF rules apply based on the investment performance during an income year, to determine taxation liabilities, rather than the overall holding period of the investment. The outcome is inequitable, particularly for private companies.

Impact of the Cost method

There are a number of practical issues arising in relation to applying the FIF methods in the case of unlisted companies, a key one being the availability of market valuations.

Privately owned entities will not obtain regular market valuations due to the cost and effort involved in preparing these (and particularly, not if the sole reason is to assist the with the New Zealand tax filing obligations of minority shareholders). However, the absence of such valuations can and does have an outsized effect for those shareholders that are required to use the FIF rules.

As noted above, the Cost method in many cases will require an initial independent valuation of the FIF interest, which can impose significant compliance costs. Based on our reading of the rules, the Cost method does not typically allow taxpayers to use their acquisition value as their opening value for FIF calculation purposes (this appears to be limited to investments that were acquired in the 2005/06 and 2006/07 income years). In any event, those investors transitioning from the transitional residence exemption, will need an independent valuation to set their opening value.

The compliance costs of obtaining an independent valuation should not be underestimated. It also relies on an investor (or a valuer) having access to financial information about the company.

There will be many cases where an independent valuation is simply not feasible, or robust, due to lack of information. In practice, due to cost and data limitations, we expect that proxies are likely to be widely used.

Even when privately owned companies publish their own valuations, their purpose needs to be kept in mind. Valuations are usually obtained when such companies are seeking additional financing. As a result, valuations can often be inflated, based on the future expectations of the company's performance, rather than its current operating results. The results of internal (informal) valuations based on current business operations and external valuations for funding purposes can vary widely, and taxpayers are then locked into using the higher valuation prepared for financing purposes. We have seen this occur in practice where shareholders were provided with an externally prepared valuation based on a 5x multiplier of earnings, yet the current operations of the business were trading at a much lower rate and the shareholder was aware of this because of their role as an advisor to the organisation.

In summary, the Cost method imposes requirements which will be impractical for most investors, to comply with the letter of the law.

The Cost method also assumes a 5% rate of annual growth in this initial valuation (unless reset, but even here there is five-year waiting period, and the need to undertake a new independent valuation) when this may not actually the be the case. As this annual uplift factors into the FIF taxable income calculation, this has a real cash impact. As noted earlier, this is further exacerbated by the fact that there is no mechanism to recover any tax paid on FIF income in the event an investment declines in value. Investments in startups fail regularly (studies suggest up to 90% of ventures fail[1]) and shareholders do not necessarily get their original investment returned to them. In this situation, they have received no income or capital growth yet, are required to pay income tax each year as if they have, under the Cost method. Moreover, the FIF income also gets taken into account for non-tax purposes (such as calculating *Working for Families* tax credits and other social policy entitlements or obligations).

Misalignment of tax payment and cash-flow

Paying tax on deemed income (based on an estimated investment value) rather than on the income streams actually received means that shareholders may not have sufficient funds available to satisfy the resulting FIF tax liabilities. For start-ups, and companies focussed on growth, earnings will be retained in the company rather than distributed to shareholders. Consequently, taxpayers will need to fund their tax liabilities from other income sources, or sell down assets, ultimately reducing the future tax base of New Zealand.

This is further complicated by the illiquid nature of some shareholdings. It is often difficult for shareholders in private companies to sell their shares as there is no active market for these shares. And while there is a FIF exemption for shares acquired as part of an employee share

[1] https://www.forbes.com/sites/neilpatel/2015/01/16/90-of-startups-will-fail-heres-what-you-need-to-know-about-the-10/?sh=210504d86679

scheme arrangement, there will be arrangements where shares are granted outside of formal employment arrangements, which are nevertheless subject to restrictions on disposal. For example, if the disposal would have a material market impact due to the holder being a key person in the business (such as a founder or executive).

General

These practical issues with how the FIF rules currently operate have a material impact on the decisions taken by individuals around what investments they hold and, ultimately, where they will choose to reside. In our experience, those impacted will either manage their time spent in New Zealand to remain non-resident for tax purposes (and therefore not subject to the FIF regime) or they will leave New Zealand when their transitional residence concessions expire. We do not see either of these outcomes as beneficial to New Zealand in the long term.

A practical approach to taxing these investments

To address the practical concerns around taxing on an unrealised basis and the absence of reliable valuations, we propose the introduction of an additional FIF calculation method for offshore share investments, that would treat as taxable income:

- Distributions received as a dividend; and
- Proceeds (or deemed consideration received) on disposal of the share.

The impact of the new method would be to effectively put these shares on “revenue account.” This ensures that there is no ability to avoid taxation by not paying dividends.

As a key driver of this new method is to address the financial barrier to expatriate New Zealanders and high-skilled migrants relocating to New Zealand, a critical aspect of the design will be in ensuring that the taxation on disposal aligns with how other countries are treating similar income. Applying full marginal tax rates to a disposal event has the potential to over tax if the investment is held for a significant period and also due to the cumulative gain that would be taxed in the disposal year (which may result in a higher marginal tax rate applying at the time, than if the investment continued to be taxed under the FDR or Cost methods each year).

Broadly, we envisage this new FIF method working as follows:

- The new FIF method will be available to individuals and trusts only. It is not proposed that the method be available to corporate taxpayers.
- The new FIF method would be optional (by election), meaning those that wish to apply the current FIF methods can continue to do so. If an election is made to apply the new method, it would be irrevocable – i.e., would apply for the holding period of the investment (including any additional shares acquired of the same type).
- When a taxpayer ceases to be New Zealand tax resident, or the shares are no longer FIFs, a deemed disposal calculation would be required to ensure New Zealand is able to tax the

disposal. Such a disposal event would require an independent valuation to set the deemed consideration received. Other disposal events would include the sale or transfer of the shares (subject to any rollover relief that may be appropriate).

- At the time of a disposal event, a deduction would be allowed for:
  - The cost of the shares, if the shares have not previously been subject to any other FIF method; or
  - The most recent opening value, if the shares have been taxed under the Cost or FDR method. We believe this is reasonable as the Cost or FDR methods will have appropriately taxed any capital appreciation up to the income year the new FIF method is applied.

  For new returning New Zealanders and migrants, cost could be set at the value of their shares at the time of becoming NZ tax resident or ceasing transitional residence (whichever is applicable). While this may require an independent valuation, it would ensure that any gains while non-resident or during the concession period are not taxed. Alternatively, as a compliance cost saving measure, there should be the option to use original cost.
- A foreign tax credit should be available, up to the New Zealand tax liability on the disposal, if the foreign jurisdiction has the primary taxing right on the disposal of the shares and capital gains tax is paid in the other jurisdiction.
- As noted above, we consider that a tax rate which appropriately recognises the capital nature of the income that will be taxed should be considered. The approach to determining an effective tax rate could potentially be aligned with the schedular method adopted in respect of the taxation of foreign superannuation, or by introducing a specific rate which is consistent with that applied in other OECD jurisdictions. We note that Australia, for example, taxes capital gains at an individual's marginal tax rate, but with a 50 per cent discount when the asset has been held for 12 months or more. Similarly, the United Kingdom and the United States do not align their capital gains tax rates with income taxes, instead limiting the capital gains tax rate at 20 per cent if certain criteria are met.

There are other design issues that will require further consideration, including:

- Whether FIF losses should be available to offset other FIF income, or ringfenced. We can see merits to both approaches.
- The types of offshore share investment for which this new FIF method could be applied and taxpayers who may be eligible to apply the method.
- Reporting of these investments to Inland Revenue, if any.

We would be happy to work through these additional considerations with you.

Benefits of our proposed solution

We believe the benefits of our proposed new FIF method are as follows:

It is consistent with the integrity rationale of the FIF regime, which is to prevent avoidance of New Zealand tax on offshore investments, while addressing major concerns with the current FIF methods. These concerns include:

- Taxing on an unrealised basis.
- Taxing based on an inaccurate deemed market value when valuations are not available (and when available are typically not fit-for-purpose).
- Tax liabilities arising when the shares may be loss making, with no ability to get a refund.
- The absence of cash-flow from the investment to meet resulting tax liabilities.
- The risk of double taxation from application of the current FIF methods and other offshore tax regimes, which tax on disposal.

It fits within the existing framework of the Income Tax Act, by treating the relevant shares as revenue account property. Therefore, we do not consider that significant amendments will be required to the existing FIF rules in subpart EX of the ITA 2007, to add this new method. We have set out, in Appendix 1, our analysis of the proposal against a range of tax policy principles.

It is easy to understand, and therefore likely to be more acceptable than the current FIF rules which are an anomaly in international taxation, whereas capital gains taxes are relatively common. Importantly, it betters aligns the New Zealand tax treatment of these shares with other jurisdictions, which are competing for the same people, skills and investment. Alignment will also help to better manage any exposure to double taxation.

Next steps

We would welcome the opportunity to discuss our proposal further with you as we believe this change would be of significant economic benefit to New Zealand, while ensuring the tax base is suitably protected.

Yours sincerely

RME Armour

Rebecca Armour

Appendix 1

Evaluation against key tax policy principles

We acknowledge that any proposed change to the tax system need to be carefully evaluated against principles for good tax policy. The tax principles we have considered are equity, integrity, efficiency, compliance and administration costs and certainty/predictability.

Equity

This principle of horizontal equity is that people in similar economic situations are treated similarly.

Presently, the FIF rules do not achieve this principle as investors holding portfolio FIF investments are taxed on a significantly different basis to investments in New Zealand and certain Australian (FIF-exempt) shares. This is particularly the case with loss making FIF investments. The proposal will put these investments on a broadly similar tax footing, thereby increasing horizontal equity.

Integrity

This principle looks at whether taxes are applied with integrity, or whether there are large gaps or lack of enforcement that means some groups do not contribute to the tax system when they should.

We believe that our proposal supports the integrity of the international tax rules. Subjecting these investments to revenue account treatment prevents taxpayers avoiding or indefinitely deferring the payment of tax on their offshore investment income. Further, the deemed disposal feature of the proposed approach will support the protection of the New Zealand tax base in the event taxpayers permanently leave New Zealand.

Efficiency

The principle of efficiency is to ensure that the tax system raises revenue by imposing the least economic and social costs, such that the impact of the tax on behaviour is minimised.

As noted earlier, we consider that the current FIF rules are a genuine financial barrier to expatriate New Zealanders and new migrants choosing to relocate to New Zealand, due to the compliance costs and perceived unfairness of the regime. Therefore, the international tax rules are directly impacting economic behaviour.

We believe that our proposal will have significant efficiency benefits by:

- Aligning the New Zealand tax treatment of these investments with the tax regimes that would apply in comparable countries and thereby limiting the risk of double tax. (This will be particularly relevant for US citizens or green card holders who are either returning to New Zealand or seeking to reside here.)

- Tax will be imposed when a taxpayer has economically benefited (whether in the form of a dividend or a realised gain). Tax would not be imposed on paper returns or when investments are in fact loss making.

Compliance and administration costs

Compliance costs refer to the costs which taxpayers incur in meeting their tax obligations (for example, the price of seeking professional services). These costs include non-monetary costs (e.g., the time and stress which taxpayers incur in determining and meeting their obligations). Administration costs are the costs faced by Inland Revenue in administering the tax system.

As noted earlier, the current FIF rules are not fit-for-purpose due to the significant double taxation risks and the need to fund tax liabilities on unrealised amounts. These factors add significantly to the stress and costs of compliance.

Further, the requirement to seek an independent valuation can impose significant monetary costs and/or require taxpayers to spend significant effort attempting to source valuation information that is accurate. In practice, this is a very imprecise exercise which does not recognise the challenge of obtaining information, particularly if it is simply to assist a New Zealand investor comply with their tax obligations and there is no other business need for it. As a result, we would question the ability for taxpayers to accurately comply with the requirements of the Cost method.

Our proposal seeks to minimise compliance costs by removing the need to obtain independent valuations (other than in specific defined circumstances), reducing the amount of work required by taxpayers to comply with the FIF regime while managing tax obligations and tax credits in multiple jurisdictions and generally aligning the taxation treatment to when there are suitable cash-flows.

There will be administration benefits for Inland Revenue as the income returned will be more readily verifiable and less time would be required reviewing and investigating the calculation of income that is returned under the various FIF calculation methods.

Certainty/predictability

The principles of certainty and predictability refer to the ability of taxpayers to reliably determine their tax liabilities in advance. This can have important implications for investors' willingness to make long-term decisions, which will in turn affect the level of economic activity within a jurisdiction.

The current FIF rules offer no certainty to affected taxpayers and taxes independently of actual investment performance. Current international tax settings therefore have an adverse impact on economic activity as it is driving away investment from New Zealand. This is clear from our direct discussions with clients and other publicly available information on New Zealand’s desirability as a destination.

Our proposal will provide certainty and predictability by ensuring that tax is paid on actual returns, not paper gains or deemed income which has no basis in reality, and when there is cash-flow to fund the tax liability.