



# FIF Regime Brief

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## Background

- The foreign investment fund (FIF) regime is part of our international tax rules. It is a companion to the controlled foreign company (CFC) regime.
- The thrust of the regime is to tax equity investments held in foreign entities by New Zealand residents.
- A complex and comprehensive regime with limited exemptions.
- Substantially directed to tax foreign “portfolio” equity investments, where investment in a foreign company is less than 10%.
- An income interest in a FIF of more than 10% is taxed in substantially the same manner as income interests in a CFC.
- Foreign investments that are in the nature of a debt investment are likely to be subject to taxation under the financial arrangements rules.

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## FIF Income Arises

- A New Zealand resident, who is not a transitional resident.
- Has a right in a FIF attributing interest, which is
  - a direct income interest in a foreign company/unit trust,
  - a beneficiary or member of a FIF superannuation interest, or
  - a right to benefit from a foreign life insurance policy.
- Non of the FIF exemption applies.
- Income is calculated using one of the FIF calculation methods.
- Taxation of FIF income is generally the only tax imposed on investment subject to the FIF rules. FIF loss is only allowed as a deduction in very limited situation and is generally ring-fenced.

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## Key FIF Exemptions

- Natural person \$50,000 cost threshold.
- Exemption for shares in ASX-listed Australian companies (other than stapled stock and must be solely Australian resident and maintain a franking account. Refer to IR871 for a list of exempt companies).
- Certain Australian unit trust exemption (must be solely Australian resident, has a NZ RWT proxy, and meet certain share turnover/distribution requirements).
- Interest of 10% or more in an Australian resident FIF exemption.
- Interest of 10% or more in a CFC exemption.

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## Current FIF Calculation Methods

- **Fair dividend rate method (FDR).** FIF income is 5% of the market value of the FIF interest at the start of a tax year plus any quick sale adjustment. It's the default method unless it's not practical to use or prohibited (e.g. for non-ordinary share or as determined by the IRD).
- **Comparative value method (CV).** Compare value of the fund at the end of the tax year with value of the fund at the start of the year, adjusting for any contributions to or distributions from the fund. Available to natural person/family trust and it's used for non-ordinary share.
- **Cost method.** FIF income is 5% of the cost of the FIF interest plus any quick sale adjustment. Cost base is uplifted by 5% for each year of holding. Can only be used if FDR method is allowed but not practical to use.

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## FIF Calculation Methods Cont.

- **Deemed rate of return method.** FIF income is the book value of the FIF interest multiplied by a prescribed rate of return. It is used for non-ordinary share when use of CV method is not practical.
- **Attributable FIF income method.** No FIF income/loss if FIF is a non-attributing active FIF. Otherwise, passive income is attributed as FIF income. Can only be used for FIF interest of 10% or more and adequate financial records are available.

Note: Same method must be applied to all FIF interests unless the calculation method is not permitted for a particular FIF interest. Natural person/family trust can change from year-to-year between the FDR and CV method. The change must be for all FIF interests in the same category, no "cherry-picking". Non-ordinary share generally involved one with a guaranteed return.

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## FDR and CV Methods

- FDR method:
  - Formula:  $(0.05 \times \text{opening value}) + \text{quick sale adjustment}$ .
  - The quick sale adjustment rules are designed to tax shares that are bought and sold within the same income year. These shares are taxed on the lower of 5% of the cost of the purchase or the actual gains made on these quick sales (i.e. the lower of peak holding adjustment and quick sale gains. See enclosed example for explanation).
- CV method:
  - Formula:  $(\text{closing value} + \text{gains}) - (\text{opening value} + \text{costs})$ .
  - gains are all amounts derived during the income year from holding or disposing the interest, inclusive of imputation credits and foreign tax credits. Costs are the sum of total expenditure incurred on acquisitions during the income year and foreign income tax paid on income of the FIF.
  - This method takes into account capital appreciation as well as currency fluctuation of the fund during the year. Thus FIF income may arise even if the fund performs badly.
- IRD online FIF calculator (<https://interact2.ird.govt.nz/forms/fifcalc/>).
- Additional reading: IR461 A guide to foreign investment funds and the fair dividend rate (<http://www.ird.govt.nz/resources/7/6/766e61804d5325af8370e7057ca1dd2d/ir461.pdf>).

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## Example

Jane holds 10,000 shares worth \$30,000 in Co A and 10,000 shares worth \$50,000 in Co B on 1 April 2007. On 30 May she buys another 1,000 shares in Co A for \$4,000 and on 15 October she buys another 4,000 shares in Co A for \$20,000. On 30 November she receives dividends of \$1,000 from Co A and \$2,000 from Co B. On 2 February 2008 Jane sells 3,000 of her Co A shares for \$15,000. At the end of the year Jane's remaining 12,000 Co A shares are worth \$48,000 and her 10,000 Co B shares are worth \$55,000.

Jane would be taxable on \$4,000 (that is, 5% of \$80,000) under the standard fair dividend rate method. However, Jane also bought 3,000 shares in Co A during the year that she sold before the end of the year. The average cost of these 3,000 shares is \$4.80 (\$24,000 cost of acquiring new shares in the year divided by 5,000, the number of new shares). Her quick sale adjustment for these shares is the lesser of her peak holding adjustment and her quick sale gains. Her peak holding adjustment is:  $5\% \times 3,000$  (quick sales)  $\times \$4.80$  (average cost) = \$720. Jane's quick sale gains takes into account the total proceeds from holding or disposing of shares she bought and sold in Co A during the year. These proceeds include a \$200 dividend, which is the pro rata share of the \$1,000 dividend paid on the Co A shares that is attributable to the 3,000 shares bought and sold in the year (the 3,000 shares sold divided by the total 15,000 shares multiplied by the \$1,000 dividend). Jane's remaining proceeds are the \$15,000 sale proceeds from the 3,000 quick sale shares. From the total proceeds she subtracts the expenditure on the quick sale shares, which is the number of quick sale shares (3,000) multiplied by their average cost (\$4.80) as calculated above. Therefore Jane's quick sale gains are:  $(\$15,000 + \$200) - \$14,400 = \$800$ . Jane's quick sale adjustment is therefore \$720 (being the lesser of the peak holding adjustment of \$720 and the quick sale gains of \$800). Jane's income under the fair dividend rate method is the sum of the opening value result (\$4,000) and the quick sale adjustment (\$720). This is \$4,720.

Jane could be taxable on a lesser amount if she is able to show that her total return under the comparative value method is less than \$4,720 (available only for natural persons and family trusts). Jane calculates that her actual return is:  $(\$103,000 + \$15,000 + \$3,000) - (\$80,000 + \$24,000) = \$17,000$ . As Jane's total return is more than \$4,720, she is taxed at her personal tax rate on \$4,720.

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