Trust e.Speaking

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Brought to you by

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Welcome to the first issue of *Trust e.Speaking* for 2007. We hope you find the articles of interest. If you would like to talk further about any topic in this newsletter or about trusts in general, then please do not hesitate to contact us.

Residential Care Subsidies

- Means testing by WINZ

The Effect on Trusts of Offshore Equities Investment Tax Reforms - Summary

- Tax changes from 1 April 2007

Offshore Equities Investment Tax Reforms – by ING (NZ) Limited

Warning: 31 March 2007 is fast approaching. If your trust has a balance date of 31 March then we recommend supplying your trust's accountant with all the information required to enable preparation of financial accounts for your trust as soon as possible after 31 March. This is particularly helpful in the event that your trust intends distributing income to beneficiaries prior to 30 September 2007.

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Residential Care Subsidies

- Means testing by WINZ

The law regarding financial means testing for the Residential Care Subsidy in respect of Rest Homes (the subsidy) changed almost two years ago. However, many people are still unaware of the provisions that affect those who transferred assets to a trust or trusts in order to possibly obtain a rest home subsidy. For the purposes of this article, we reiterate the legal position but focus particularly on the gifting aspects of asset limits.

Since 1 July 2005 Work and Income NZ (WINZ), when assessing assets, now not only takes into account gifting in the last five years before a subsidy application is made, but also considers all gifting, that is gifting that also took place more than five years before the date of an application. This can have serious implications for subsidy applicants, particularly for couples where only one partner is applying for the subsidy.

The subsidy provides financial assistance to eligible people who require long term residential care in a hospital or rest home. WINZ is required to assess the assets and income of people aged 65 years and over who apply for the subsidy. This means assessment will help WINZ decide whether the client is eligible for the subsidy and how much the applicant must contribute towards the cost of their care. To be financially eligible, the applicant must not have income or assets above the asset limit relevant to their situation. The asset limit increases by a maximum of $10,000 each year. Current asset limits from 1 July 2006 to 30 June 2007 are: Single ($160,000); Couple – both in care ($160,000); Couple – one in care (either $160,000 or $65,000 plus house and car)

Gifting

When assessing an applicant's assets, WINZ takes into account any gifting by the applicant or their partner or spouse. There are limits on how much can be gifted and any gifting over the allowed limit may be added back into the financial means assessment. It is important to note that the total amounts allowed are *per application,* not *per couple*. In other words if a married couple has been gifting $27,000 each per year, then WINZ only treats one-half as being permissible. Where both partners go into care, then the allowable gifting values double.

The law from 1 July 2005

In considering subsidy applications WINZ examines gifting *during* the five years prior to an application being made. WINZ also considers any gifting that occurred *more than* five years after a subsidy application is made. Certain amounts are permitted in each time period, but WINZ requires all amounts in excess of its imposed limits to be added back into assessable income for the purposes of its financial means assessment.

For the five years prior to an application being made WINZ will permit as 'allowable gifting' $5,000 per year. For gifting that took place prior to the five year period WINZ now only permits $27,000 per application, ie: if a married couple have been gifting $27,000 each ($54,000 in total) prior to the five year period, then $27,000 is treated as being allowable, and the other $27,000 is likely to be added into the applicant assets for the purposes of calculating whether or not a subsidy is possible.

While it is important to be aware of the changes relating to subsidy eligibility, it is also important to note that those changes do not affect all potential applicants. One such example is a single person who has been gifting $27,000 per year will still have the entire $27,000 gifted more than five years before an application is made treated as 'allowable gifting'. In fact such a person will be better off: $5,000 worth of any gifting per year made in the immediate five years preceding an application will also be treated as 'allowable gifting'.

However couples where only one partner is applying for the subsidy who have each been gifting $27,000 per year over that five year period will be affected. In that instance it is likely that $27,000 of the amount gifted per couple per year will be added back into the couple's assets.

The Effect on Trusts of Offshore Equities Investment Tax Reforms - Summary

- Tax changes from 1 April 2007

Reforms to the method in which offshore equities are taxed have been widely publicised over the past few months. In essence, capital gains on offshore equities held by New Zealand tax payers that were previously not subject to income tax will now be subject to income tax commencing 1 April 2007.

This article summarises the changes that will occur from 1 April onwards. For a more detailed discussion please read the article on Pages 4-6 that has been kindly supplied by ING (NZ) Ltd.

The provisions in the Taxation (Savings Investment and Miscellaneous Provisions) Act 2006 is of particular interest to trusts that hold overseas equities for two major reasons:

1. Trustees of family trusts should undertake a review of overseas investments to ascertain whether it is still appropriate for those investments to be held in their existing format, and
2. Trustees should be aware that the exemption of $50,000 per person that has been provided by the legislation is not available to family trusts.

Overseas investments

Overseas investments can be held by individuals and trusts using a range of ownership options, including (amongst others) directly investing in public and private company shares, directly investing in overseas-based companies which then invest in a range of investments (which may or may not include other companies) throughout the world, and investing in unit trusts and associated investment entities, both in New Zealand and overseas.

Trustees should seek advice from their trust's financial adviser concerning the likely effect that the new legislation will have on the present overseas investments of their trust/s. Please note that we are not advocating that a trust necessarily changes either its present range of investments, nor the method by which such investments are held. However, we do strongly recommend that you consult with your trust's financial adviser in order to ascertain the implications relating to your particular trust/s.

Exemption not available for trusts

The ING article lists four main exemptions to the new international tax rules. In particular a NZ$50,000 exemption is provided per individual. However such exemption does not extend to family trusts. If a trustee wants to take advantage of the personal exemption, we recommend discussing strategies with your financial adviser. It may be possible, for example, to transfer tranches of $50,000 of the overseas investments from a family trust to either trust beneficiaries, or to people who have lent funds to the trust. It is likely that transfers such as these can be formalised by either treating the transfers as repayments of debts (if monies are owed by the trust) or by using a trust's ability to distribute capital. However, one should also take into account the costs of transferring overseas investments; the transfer of certain investments will attract expenses such as stamp duty and/or withdrawal and fresh application charges. Furthermore, the possible disadvantages associated with removing assets from a trust should also be considered.

Conclusion

The new offshore equities taxation legislation will affect the taxation of overseas equities held by trusts. This article can only provide a summary of the likely effects – talk with your financial adviser about the taxation implications for your particular trust/s and before taking any action!

Offshore Equities Investment Tax Reforms
by ING (NZ) Limited

The Taxation (Savings Investment and Miscellaneous Provisions) Act 2006 was passed on 12 December 2006. The Act includes significant changes to the taxation of investment income in New Zealand, which may impact on the returns from offshore equities held directly, and via managed funds. These offshore tax reforms generally apply to income years beginning on or after 1 April 2007.

Tax changes on offshore portfolio investments

Generally, the new international tax rules will apply to interests of less than 10% in any offshore equity. This includes offshore resident funds (unlisted unit trusts) and offshore resident listed equities – other than Australian resident-listed companies. All these investments will be subject to the new tax rules, unless a Foreign Investment Fund (FIF) exemption applies.

Taxation of offshore portfolio investments in shares (FIF interests)

There are several FIF calculation methods. The fair dividend rate (FDR) method is the default method and will apply to most offshore equity investments.

The FDR method will *not* apply to:

- Fixed rate shares
- Non-participating redeemable shares
- Vehicles that have assets of which 80% by value consist of NZ dollar financial arrangements (debt securities), and
- Offshore investments that offer a guaranteed return.

Taxation of these investments will be calculated under comparative value (CV) method. Under CV, tax will be payable on the market value movements, distributions and realised gains; tax losses will be deductible to the investor.

The Inland Revenue Department (IRD) has the power to issue determinations, which could exclude certain investments from being subject to FDR and make them subject to CV. These determinations will apply prospectively, which can be from the beginning of the next tax year or the date of determination.

We understand that the IRD is currently considering a determination excluding from FDR offshore funds that invest in financial arrangements and that are fully hedged back to NZ dollars. A special report will be released shortly by the IRD on the investment income reform, to include comments in respect of offshore funds with debt securities that are fully or partially hedged back to NZ dollars. It has been indicated that any determination/s on these funds hedging into NZ dollars could apply from 1 April 2008 to provide investors with certainty on the tax treatment.

Fair dividend rate

Investors holding offshore portfolio investments directly will be taxed at their marginal tax rate on 5% of the market value of their total offshore portfolio investments held at the beginning of each tax year, plus 'quick sale' adjustment.

The quick sale adjustment will apply to shares bought and sold during the same tax year. Tax on quick sale adjustments will be calculated on the lesser of any actual gains received on the quick sales, and 5% of the cost of shares sold. If the actual return from the investments (being the market value movements and dividends) exceeds 5% of opening market value, no tax is payable on the excess.

Dividends will not be taxed separately. Equity losses will not be deductible, but foreign tax credits can be offset against the tax payable. Individuals and family trusts can elect to be taxed on their actual returns if the return is less than 5% via using the CV method.

Continued on Page 5

Continued from Page 4

Managed funds investing in offshore portfolio investments will be taxed on 5% of the average market value of their offshore portfolio, plus any quick sale adjustment. Funds that calculate daily unit prices will not have to make quick sale adjustments.

Portfolio Investment Entity (PIE) investors and revenue account holders who hold investments directly can carry forward and use the existing equity losses under the new international tax rules and the PIE regime.

Foreign Investment Fund (FIF) exemptions

There are four main exemptions to the international tax rules:

1. Where an Australian unit trust (AUT) provides a New Zealand resident withholding tax (RWT) proxy facility and a New Zealand resident investor has requested RWT be deducted from all distributions each tax year. The AUT must also meet an asset turnover requirement. This requires the unrealised gains of investment assets held by the fund to be equal to or less than three times the realised gains made on investments during the year. This asset turnover requirement was intended for equity assets only, but as written in the Income Tax Act covers all asset types. There may be remedial legislation in respect of this.
2. Individual investors whose total cost of interest in all offshore portfolio investments (excluding Australian resident-listed equities and the above exempt AUTs) does not exceed NZ$50,000. This exemption is not available to family trusts.
3. Investors in resident-listed Australian companies (ie: companies resident in Australia that are listed on an approved Australian Stock Exchange index and maintain a franking account in Australia).
4. There are also certain specific exemptions such as investments held in GPG and other similar company shares, the New Zealand Investment Trusts, venture capital companies and employee share schemes.

Any investments that fall within the FIF exemptions will be taxed on dividends only, unless the shares were acquired on a revenue account basis.

Application date

The offshore investment portfolio tax changes will apply to income years beginning on or after 1 April 2007. For those investors with a tax year of 31 March, the new rules will apply from 1 April 2007.

Managed funds with balance dates other than 31 March will apply the new offshore regime from the first day of the 2008 income year. For example, a fund with a 30 June balance date will apply the new rules from 1 July 2007. Managed funds that intend to elect into the PIE rules can elect to defer the application of the new international tax rules until the later date of the first day of the fund's 2008 income year or 1 October 2007.

Implications of the offshore portfolio investment changes

- On entry into the new offshore portfolio investment regime, an investor is deemed to have disposed of the investments at their market value. The gain/loss from this deemed disposal will not be taxable/deductible to capital account holders. Revenue account holders will be taxed on this deemed disposal, with the liability able to be paid over a three-year period
- The upside of the changes is that if the dividend yield from offshore portfolio investments is higher than 5% of the value of the investments held, then the tax payable is capped at 5%. Subject to administration costs such as meeting tax return and payment obligations, some investors may derive better net after-tax returns than under the AUT exemption or the $50,000 exemption

Continued on Page 6

Continued from Page 5

- Investors will need to determine if their interest in AUTs should be included under the NZ$50,000 exemption (if not, the FDR rule applies to the investments held in those trusts)
- If the AUT asset turnover requirement is not able to be met, the RWT proxy facility will only be available to those investors covered by the $50,000 exemption. This could mean that other investors need to file a tax return and/or make provisional tax payments
- Wrap accounts, which operate as a bare trust under an exemption certificate, may provide a simple, cost-effective method to calculate clients' liabilities, which can also then be paid through the wrap, and
- Investments in open-ended investment companies will be taxed under FDR unless the $50,000 exemption applies or it invests in assets specifically excluded from FDR.

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