Part 1 - Previous rules and new rules for overseas pensions

Previous rules

The foreign investment fund (FIF) regime was originally introduced as part of a package of reforms targeted at persons with interests in foreign entities used to accumulate income and gains outside New Zealand. Such interests could be used to defer New Zealand tax or avoid it altogether. Foreign superannuation schemes and life insurance policies were specifically targeted by the FIF measures as they were identified as a possible investment vehicle for deferring or avoiding New Zealand tax.

Pensions and annuities received from an interest in a foreign superannuation scheme or life insurance policy will be subject to tax under the FIF regime, unless the interest is specifically excluded from the FIF regime. Interests in a foreign superannuation scheme or life insurance policy will be excluded from the FIF regime if any of these conditions are met:

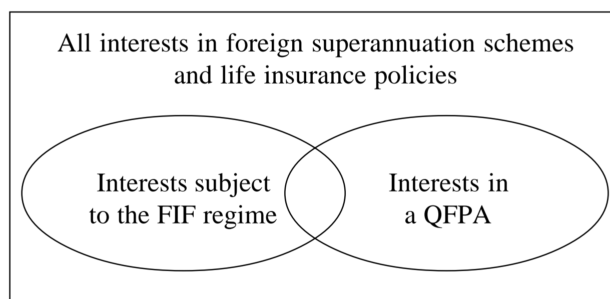
- The interest is an interest in an employment-related foreign superannuation scheme (section CG 15 (2)(c)).
- The aggregate cost of all of the person's interests in foreign entities (which would otherwise constitute an interest in a FIF) is less than $20,000 (section CG 15 (2)(d)).
- The person is a natural person and the interest was acquired before whichever of the following applies:
  - 8 pm on 2 July 1992
  - the date when the person first became resident in New Zealand
  - the date when certain exchange controls (which apply to the person and the interest) were imposed by a country or territory other than New Zealand, if those exchange controls prevent the person from deriving either any profit or gain from the interest or disposing of the interest for New Zealand currency or consideration readily convertible into New Zealand currency.
- The new resident exemption for interests in foreign life insurance policies and superannuation schemes applies (section CG 15 (2)(f)).

Persons with interests that are subject to the FIF regime must disclose that interest to the Commissioner and calculate their FIF income or loss from that interest. There are two methods prescribed by the FIF regime applicable to interests in foreign superannuation schemes and life insurance policies: the comparative value and deemed rate of return methods.

The comparative value method measures the change in market value of the FIF interest over the income year and takes this into account for both income tax and New Zealand Superannuitant surcharge purposes. Any pension or annuity received from a FIF interest is taken into account in the formula that measures the change in value.

If the deemed rate of return method applies, a certain rate of interest is deemed to be received by the beneficial owner of the entitlement on the book value of the interest in a foreign entity. This deemed interest amount is subject to income tax and surcharge. Any pension or annuity received reduces the book value, although this may be assessable if it exceeds the FIF income for that year.

The following diagram illustrates the relationship between the new QFPA rules and the previous rules. It shows that an interest in a foreign superannuation scheme or life insurance policy can be a FIF interest, and/or a QFPA interest, or neither.



The FIF regime is fully explained in our booklet *Foreign Investment Funds (IR 275B).*

New rules

Under the new QFPA rules, any pension or annuity received from a QFPA interest is excluded from the FIF regime and taxed on a receipts basis (in the same manner as salary and wages).

Essentially, a QFPA is an entitlement to benefit from a pension or annuity provided by a foreign entity, if the consideration provided in return for the pension or annuity was provided at a time when the person was not resident in New Zealand, or within a qualifying period after becoming resident. The qualifying period will be between three to four years depending on the date the person became a New Zealand resident.

For surcharge purposes any pension or annuity paid from a QFPA interest will be subject to surcharge only on fifty percent of the gross amount of the pension or annuity.

This surcharge treatment is also extended to certain interests that are specifically excluded from the FIF regime and also fail to meet the QFPA definition because the contributions were made while the person involved was resident in New Zealand. This is explained fully in part 4 of this TIB, which discusses the surcharge treatment.

Summary flowchart - is the interest an interest in a qualifying foreign private annuity?

Reason for the new rules

The objective of the amendments is to give effect to paragraph 3.2.1 of the Accord on retirement income policies. They do this by aligning, as far as possible, the taxation and surcharge treatment of foreign-sourced private pensions and annuities with the treatment of their domestic-sourced equivalents. However, this is not always possible because of the way New Zealand taxes life insurance funds and superannuation schemes, so differences remain.

The principal difference between the two treatments is that domestic pensions and annuities are exempt from income tax in New Zealand because contributions have been made from tax-paid income, and the income derived by trustees of the superannuation scheme or the life insurance fund is assessable as it is derived.

On the other hand foreign pensions may not have been funded from tax-paid contributions. Moreover, the superannuation scheme or life insurance company may have been taxed concessionally, or not taxed at all, on

its earnings. Foreign pensions and annuities will therefore still be assessable for income tax when paid to a New Zealand resident.

In policy terms, to give effect to the principles expressed in the Accord it was necessary to ensure that the taxation treatment of the contributions and foreign schemes' earnings was taken into account. It was also necessary to ensure that New Zealand's superannuation and life insurance regimes were not undermined by weakening the FIF regime.

These requirements are reflected in the new rules in two key areas:

- Only those foreign private pensions and annuities for which the contributions were made primarily when the beneficial owner of the pension or annuity was non-resident are excluded from the FIF regime and eligible for the fifty percent surcharge exemption[1]. This ensures that the FIF regime still applies if contributions to foreign superannuation and life insurance policies are made when the beneficial owner is primarily resident in New Zealand.
- Foreign pensions are not exempt from income tax in New Zealand and, for surcharge purposes, fifty percent of the gross foreign pension or annuity is subject to the surcharge. This acknowledges the potentially concessional taxation of foreign superannuation schemes, and is also in accordance with international norms regarding the taxation of foreign pensions.

1 An exception to this applies for surcharge purposes for those interests in foreign entities that are excluded from the FIF regime under sections CG 15 (2)(d) to (f). This is discussed in part 3 of this TIB.

Part 2 - Qualifying foreign private annuity definition

Section OB 1 (and 245R of the Income Tax Act 1976) has been amended to insert a definition of "qualifying foreign private annuity", or QFPA.

Analysis of the main parts of the definition

The definition of a QFPA is directed at interests in foreign entities, namely interests in private foreign superannuation schemes and life insurance policies, that provide a pension or annuity in return for consideration provided by or on behalf of the person entitled to benefit. Therefore the definition excludes pensions and annuities received from foreign social security schemes, which are likewise excluded from the FIF regime.

The definition is targeted primarily at interests that were acquired while a person was not resident in New Zealand. For practical reasons it was decided to allow limited contributions to be made while the person was resident.

For the purposes of this analysis, the definition is broken down into its component parts and discussed separately. The component parts are shown in the shaded boxes.

Qualifying Foreign Private Annuity

> "Qualifying Foreign Private Annuity" means *an entitlement of a natural person to benefit* from a pension or annuity provided by a *foreign entity* while the person is resident in New Zealand, if -

Entitlement of a natural person to benefit, in this context, describes the right a person has in relation to a foreign entity to receive a pension or annuity from the entity. This is also covered by the definition of "entitlement of the person to benefit" contained in section OB 1, which ensures the term includes vested, contingent and discretionary entitlements.

A superannuation scheme that provides for the pension to be paid to a person's spouse on the death of that person would be a contingent interest and come within the definition "entitlement of the person to benefit". However, this expanded definition is targeted at the person who has a present entitlement to benefit. Inland Revenue does not interpret this provision as applying to a spouse's contingent interest in this circumstance. Therefore if a widow or widower receives a pension from a deceased spouse's superannuation scheme, Inland Revenue will accept that the pension is received from a QFPA if the spouse's interest was a QFPA immediately before death.

Because the legislation focuses on the entitlement of the person to benefit, it does not matter who contributes to the foreign superannuation scheme or life insurance policy. For example, contributions could be made by an employer, parent, guardian or spouse without disqualifying the interest from the QFPA rules. In the case of a life insurance policy, the person entitled to benefit may not be the insured person, but rather an employer or spouse. The principal point is that the legislation focuses on the person who is entitled to benefit.

Foreign entity is defined in section OB 1 as a foreign company. The other relevant parts of the definition specifically include:

- natural person issuers of life insurance policies offered and entered into outside New Zealand
- foreign superannuation schemes.

"Foreign superannuation scheme" and **"superannuation scheme"** are defined terms. Specifically included in

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paragraph (c) of the definition of "superannuation scheme" are arrangements that are constituted under a foreign country or state's legislation principally to provide retirement benefits to natural persons. Therefore foreign pensions received from a superannuation scheme established by legislation of a foreign country are included within the definition of superannuation scheme. This is regardless of whether any contributions were made to the scheme by the person who is the beneficiary or recipient of the annuity and regardless of whether the contributions were compulsory or not.

However, social security pensions and benefits provided under a foreign country or state's legislation that is equivalent to the Social Security Act 1964 are specifically excluded from the definition of superannuation scheme and therefore from the QFPA rules. For the same reason the entitlement to a social security pension does not constitute an interest in a FIF. Subject to the provisions of any relevant double taxation agreement, the income from these pensions is therefore assessed in New Zealand on a receipts basis.

Paragraph (a) of the QFPA definition[2]

The consideration for the entitlement to the pension or annuity is provided to the foreign entity-

(i) At a time when the person is not resident in New Zealand; or

(ii) At a time when the person is resident in New Zealand falling before the first day of the 4th income year succeeding the income year in which the person last becomes a resident of New Zealand; or

(iii) From the accumulated balance or proceeds of an interest of the person in a superannuation fund and that interest is commuted or transferred in anticipation of, or following, the person ceasing to be a resident of New Zealand; and

Subparagraph (i) (the non-resident contributions test) ensures the policy objectives of the QFPA rules are achieved, by requiring all contributions to have been made while the person was not resident in New Zealand. That is, permitting only those people who contributed to foreign superannuation schemes and life insurance policies while they were non-resident to pay tax on a cash basis (as opposed to including the pension or annuity in FIF income calculations) will not undermine the policy objectives of the FIF regime or the domestic superannuation and life insurance regimes.

Therefore the FIF regime still applies in either of these situations:

- if the consideration was provided for the interest when the person was resident in New Zealand
- if the person continues to make contributions to the foreign superannuation scheme or life insurance fund after the time defined in paragraph (a)(ii) of the definition has expired.

2 Paragraph (a) contains the non-resident contributions test.

Exceptions to the principal rule

Subparagraphs (ii) and (iii) contain two exceptions to the principal rule in subparagraph (i).

Subparagraph (ii)

This exception allows people to continue to contribute to a foreign superannuation scheme or life insurance policy for a limited period of time after they assume or reassume their New Zealand resident status.

The exception was designed for reasons of practicality and to parallel the new resident exemption in section CG 15 (2)(f). It permits people to have some flexibility to continue to make contributions to a foreign superannuation scheme or life insurance policy while resident in New Zealand.

For instance, without this exception those people who visit New Zealand and later decide to emigrate to New Zealand would not meet the QFPA definition in respect of their foreign superannuation scheme or life insurance policy interests if they continued to contribute to the scheme following the date they become resident.

The operation of subparagraph (ii) is best explained by way of example.

Example 1

Ms B arrives in New Zealand on 14 May 1996 for a holiday, and subsequently decides to retire here. Under section OE 1 (2) she is deemed to be resident from 14 May 1996.

The income year in which she became resident is the year ending 31 March 1997. Thus Ms B has until 31 March 2000 (being the day before the first day of the fourth income year succeeding the year ended 31 March 1997) to cease contributing to her foreign superannuation scheme before she will fail to meet the definition of a QFPA.

Example 2

Mrs P, who was previously resident in New Zealand, returned permanently to New Zealand on 11 July 1997, after an absence of 12 years. She continues to contribute to her foreign superannuation scheme until her retirement in 2005.

To meet the definition of a QFPA she may continue to contribute to her foreign superannuation scheme until 31 March 2001, being the day before the first day of the fourth income year succeeding the year ended 31 March 1998.

In this case the definition of a QFPA is not met because she continued to contribute to the foreign superannuation scheme after 31 March 2001.

In addition, the new resident exemption in section CG 15 (2)(f) will not apply as *the time* did not fall before the first day of the fourth income year succeeding the income year in which she *first* became a resident of New Zealand. In this case

Mrs P was resident in New Zealand from birth. She will therefore have an interest in a FIF from the date she became resident in New Zealand again (11 July 1997).

Example 2 also illustrates the difference between the test in section CG 15 (2)(f) (the new resident exemption) and the test used in the QFPA definition. For QFPA purposes the test is taken from the end of the income year in which the person *last* became resident in New Zealand. However, in the temporary resident exemption in CG 15 (2)(f), the test applies from the income year in which the person *first* became resident.

Thus, to ensure the definition of a QFPA is met and also avoid the application of the FIF regime, contributions to a foreign superannuation scheme or life insurance policy will need to cease before the expiration of the period ending on the first day of the fourth income year succeeding the income year in which a person becomes resident in New Zealand. This was illustrated in example 1 and would also be the case in example 2 if Mrs P had ceased making contributions on or before 31 March 2001.

Subparagraph (iii)

This provision is the other exception to the non-resident contributions test. Without this exception people who emigrated from New Zealand may not meet the QFPA definition if they return to reside permanently in New Zealand. This is because commuting[3] or transferring proceeds of a superannuation scheme from New Zealand to a foreign scheme would, for these purposes, be a contribution to a foreign entity. The definition of a QFPA would not otherwise be met if the proceeds were commuted or transferred while the person was still resident in New Zealand.

Example 3

Mr C, a New Zealand resident who worked for a British based multinational company, left New Zealand on 30 June 1977. Before that time, and in anticipation of Mr C leaving New Zealand, his employer commuted his interest in their New Zealand based superannuation scheme to the company's British-based superannuation scheme.

In the absence of subparagraph (iii), if Mr C later returned to New Zealand his interest in his employer's superannuation scheme would not meet the definition of a QFPA. That is, Mr C would not have met the non-resident contributions test as he was still resident at the time his interest was commuted.

However, subparagraph (iii) ensures that Mr C does not breach the non-resident contributions test. Accordingly, assuming the other parts of the QFPA definition are met, his interest in the foreign superannuation scheme will qualify as a QFPA.

3 Commuting is the process of converting a pension to a lump sum. The lump sum is determined by an actuarial projection of interest and mortality rates to produce a commutation factor which is then multiplied by the amount of the pension to produce the capital value.

Paragraphs (b) and (c) of QFPA definition

(b) The future benefits of the person arising from the entitlement *are not assignable* (except to a spouse under a matrimonial property arrangement) unless the value of the future benefits is substantially decreased as a consequence of the transfer; and

(c) The future benefits of the person arising from the entitlement *are not able to be surrendered, charged, or borrowed against* in exchange for a current receipt of cash or other property unless the value of the cash or other property received is substantially less than the decrease in the value of the future benefits resulting from the surrender, charge or borrowing:

Assignments

Paragraph (b) of the QFPA definition requires that the future benefits of the person arising from the entitlement *are not* assignable. This means that an interest in a foreign entity will not be a QFPA if the scheme or fund in which the rights to the pension or annuity are held has a provision in its deed, policy or contract which permits the pension or annuity to be assigned and the law governing the fund permits such assignments.

However, there are two exceptions to this assignment prohibition. The first is when there is a transfer to a spouse under a matrimonial property arrangement. The second is if the value of the future benefits is substantially decreased as a consequence of the transfer. This is best explained by way of an example.

Example 4

Mr G receives a purchased annuity. The contract under which his annuity was purchased allows him to assign his rights to the annuity to any other nominated person. Under paragraph (b) of the QFPA definition this would, prima facie, exclude the interest from being a QFPA.

However, Mr G's contract further provides that if the annuity is assigned, it will be reduced by a figure of 15 percent. That is, when the annuity is transferred its value will be 15 percent less than what it would have been had the assignment not taken place.

In this case his annuity may still qualify as a QFPA if the 15 percent reduction in the value of the annuity can be regarded as a substantial reduction. It will be necessary in each case to determine what constitutes a substantial reduction in future benefits (see discussion on the meaning of "substantial" below).

Note that if Mr G's contract allowed him to transfer the annuity to his spouse then the QFPA definition would have been satisfied regardless of whether there is a reduction in future benefits or not.

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Surrender, charge or borrowing

Paragraph (c) of the QFPA definition requires that the future benefits are not able to be surrendered, charged or borrowed in exchange for a current receipt of cash or other property. In this context the reference to *future benefits*, includes any surrender, charge, or borrowing of the accumulated balance or value of the current entitlement as this directly affects the level of future benefits.

As with assignments, note that the law, as enacted, requires only that the terms of the superannuation scheme or life insurance policy contain a provision which permits the surrender, charging or borrowing for it to fail the QFPA definition. Thus, even though a person may never exercise their right to borrow from the scheme or fund, or they borrow from the scheme or fund and later repay those borrowings, the fact that the scheme or fund makes provision for surrender, charging or borrowing is sufficient to disqualify it from the QFPA definition.

As with paragraph (b), which applies to assignments, there is an exception to this prohibition. Paragraph (c) will not disqualify the superannuation scheme or life insurance policy if the value of the cash or other property received as a consequence of the surrender, charge or borrowing is substantially less than the decrease in the value of the future benefits attributable to that event. Example 5 below illustrates this exception.

Surrendered

In the context of this provision, the term "surrendered" refers to the situation when someone gives up their rights or entitlement to benefit from a pension or annuity in return for a current receipt of cash or other property. This term therefore includes such actions as withdrawing funds (including partial surrenders) or cashing up the future benefits.

Charged

In general commercial terms a charge is a binding obligation secured (or charged) upon a particular asset of the person who is under the obligation. Thus charging an asset is simply another means of borrowing against the security of an asset, which, in this context, is the entitlement of the person to benefit from a pension or annuity.

Borrowed

This too refers to the situation when someone is able to borrow a sum of money (whether from the accumulated balance of his or her scheme or policy or otherwise) from the foreign entity, or a third party, by using the entitlement to benefit as security for the borrowing.

Meaning of the word "substantially"

The use of the word "substantially", in the legislation was deliberately chosen to convey the meaning that the decrease in the future benefits must be of a large size or amount. Because the meaning of the word "substantially" is not precise it must be considered objectively in light of the facts of each case. There is no rule of thumb that can be used - what is a substantial decrease in future benefits in one case will not be a substantial decrease in another.

Measuring the decrease

For the purposes of paragraph (c) of the QFPA definition, in comparing the value of any decrease in the future benefits of the annuity with a current receipt of cash or other property, it will be necessary to measure the two amounts in the same dollar value terms.

Example 5

Mr T contributed a lump sum to a foreign life insurance policy in return for an annuity of $1,000 per month for 10 years, to start in 15 years' time. Assuming a discount rate of 8 percent, the value of that annuity in year 15 is $25,364.

Mr T withdraws $10,000 today, subject to a partial surrender of future benefits of $200 per month. The value of the future benefits surrendered ($200/month) in 15 years' time is $16,104. On the face of it, paragraph (c) of the QFPA definition is satisfied as $10,000 is substantially less than the decrease in the value of the future benefits.

However, that is not correct as it is necessary to compare the decrease in future benefits in the same dollars. The present value of $16,104 is $5,073. Given this, the current amount received of $10,000 is not substantially less than the decrease in future benefits. Mr T's policy does not satisfy paragraph (c) of the definition.

Part 3 - Relationship of QFPA rules with the foreign investment fund (FIF) regime

Section CG 15 (1) defines the types of interests in foreign entities that constitute interests in a FIF. Sections CG 15 1(b) and (c) specifically include an entitlement of a person to benefit, as a beneficiary or member, if the foreign entity is a foreign superannuation scheme; and an entitlement of a person to benefit from a policy of life insurance upon human life of which the foreign entity is the issuer.

Therefore, under section CG 15 (1) anyone who is resident in New Zealand and who has an interest in a foreign superannuation scheme or life insurance policy issued by a foreign entity will have an interest in a FIF.

The very wide nature of these definitions means that these are the only foreign-sourced pension or annuity schemes that are excluded from the FIF regime by section CG 15 (1)

- those to which one of the exemptions in section CG 15 (2) applies
- foreign social security type schemes established under legislation that is similar to New Zealand's Social Security Act 1964 - see the definition of a "superannuation scheme" in section OB 1.

QFPA interests excluded from FIF regime

Section CG 15 (2) sets out the types of interest specifically excluded from the FIF regime. This section now includes a new paragraph (g) that excludes an interest that is a QFPA from the FIF regime. The new subsection (g) states:

"CG 15 (2) An interest held by a person in a foreign entity at any time during an income year shall not be treated as an interest in a foreign investment fund -

(g) If, subject to subsections (3) and (4), at the time, the interest is a qualifying foreign private annuity."

Section CG 15 (2)(g) therefore makes it clear that an interest that is a QFPA is not an interest in a FIF. This means that any pension or annuity received from an interest that is a QFPA will now be assessed on a receipts basis.

Because the interest in the foreign entity is specifically excluded from the FIF regime, the nature of the pension or annuity received may depend on how the foreign entity is classified for tax purposes in New Zealand. This is particularly relevant in the case of foreign superannuation schemes. For example, if the QFPA is an interest in a contributory foreign superannuation scheme, the QFPA will be an interest in a unit trust under the definition of unit trust in section OB 1. Therefore, any pension received will be assessable under the dividend rules. In the case of a superannuation scheme that is non-contributory it may be necessary to consider the trust rules.

If a QFPA is an entitlement to benefit from a life insurance policy issued by a foreign entity, the annuity will be assessable under section CE 1 in the normal manner.

Option to continue FIF treatment

Because the application date of the QFPA rules is retrospective to the beginning of the FIF regime, which applied generally from the 1993-94 income year, people who had complied with their obligations under the FIF regime (that is, disclosed and calculated FIF income from that interest) would, unless exempted, have their tax returns reassessed by the Commissioner to tax the pension or annuity income on a receipts basis.

However, this was considered particularly harsh on people who had been complying with the FIF regime, particularly if the liability under the FIF regime is less than the liability on the pension or annuity assessed on a receipts basis.

These people can therefore opt out of the QFPA rules and continue with the FIF regime. This election is provided in subsections (3) and (4) of section CG 15. A separate election is required for each FIF interest.

Section CG 15 (3)

This section applies to people who held an interest that is a QFPA at any time during an income year before the 1996-97 income year. It permits them to irrevocably elect that the interest not be a QFPA, but instead be treated as a FIF interest for the period from the beginning of the FIF regime until the end of the 1995-96 income year (or date of disposal, if earlier).

Only people who complied with the FIF regime for this period can elect to stay in the FIF regime for the period.

The election must be in writing and be given to the Commissioner of Inland Revenue before the due date for filing the person's 1996-97 tax return.

Period for which election applies

Section CG 15 (3) elections apply for the period from the start of the FIF regime until the end of the 1995-96 income year, provided the person disclosed and returned FIF income in relation to the FIF interest for the whole of that period. (If the person acquired the FIF interest after the start of the FIF regime, and/or disposed of it before the end of the 1995-96 year, and returned FIF income for the whole period the interest was held, the election will apply for the period the interest was held.)

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Because the election is only for that period, people may decide whether they wish to stay in the FIF regime (in which case they can make a further election under section CG 15 (4)) or whether they wish to switch to the QFPA rules. If they change to the QFPA rules from the 1996-97 income year onward, there is a deemed disposal of the FIF interest under section CG 23 (8) at the end of the 1995-96 income year.

As both the 1976 and 1994 Income Tax Acts apply to this period (from the beginning of the FIF regime until the end of the 1995-96 income year), the election in the 1976 Act is specifically linked to the election in the 1994 Act. This means that only one election is required for the purposes of both Acts, and that a person cannot elect for the purposes of one Act and not the other.

Section CG 15 (4)

This section permits a person who acquired an interest that is a QFPA at any time before the 1996-97 income year, and who complied with their obligations under the FIF regime for that interest, to elect irrevocably that the interest not be a QFPA, but instead be treated as an interest in a FIF, for the income years after the 1995-96 income year.

Section CG 15 (4) only applies if all of the following conditions are met:

- The interest was acquired before the 1996-97 income year.
- The requirements of the FIF regime have been met at all times up to and including the 1995-96 income year, as required by either the 1976 or 1994 Income Tax Acts.
- A written notice is given to the Commissioner, before the date on which the person is required to file their 1996-97 tax return, electing that section CG 15 (2)(g) not apply to that interest for the income years following the 1995-96 income year.

Relationship between sections CG 15 (3) and CG 15 (4)

Sections CG 15 (3) and CG 15 (4) are linked in the sense that a person cannot make an election under section CG 15 (4) independently of section CG 15 (3). That is, a person cannot use the QFPA rules for the period from the beginning of the FIF regime through to the end of the 1995-96 income year and then elect under CG 15 (4) to return their pension or annuity under the FIF regime thereafter.

Inland Revenue's booklet *Overseas Private Pensions (IR 258A)* contains forms for making the above elections. You can get a copy from any Inland Revenue office.

Interests excluded from FIF regime not eligible for election under either sections CG 15(3) or CG 15(4)

Both section CG 15 (3) and 15 (4) contain provisions to ensure that it is not possible to elect back into the FIF regime when the interest is excluded by any one of the specific exclusions provided in the FIF regime.

Relationship between QFPA and an interest in an employment-related foreign superannuation scheme

If a person has an interest in an employment-related foreign superannuation scheme (ERFSS), the interest is wholly excluded from the FIF regime if no further contributions to the scheme were made following the later of the date the person became a New Zealand resident, or the expiry of the new resident exemption. Those interests that are only partially excluded from the FIF regime because the person continued to contribute to the scheme after becoming resident in New Zealand (and the temporary resident exemption period) will continue to be interests in a FIF.

Because of the close relationship between an interest in an ERFSS that is wholly excluded from the FIF regime and the QFPA definition, the definition of an "interest in an employment-related foreign superannuation scheme" in section OB 1 has been amended to exclude interests that are a QFPA.

Although, in the absence of this amendment, these two exemptions from the FIF regime could have applied concurrently without causing any problems, it was considered appropriate to amend the definition of an interest in a ERFSS to clarify that the QFPA regime took precedence.

Part 4 - New Zealand Superannuitant surcharge

Two key definitions have been amended to ensure that only one-half of income received from the following is taken into account for surcharge purposes:

- QFPAs
- interests in a foreign entity that would have been FIF interests but for certain exclusions[4] and would also have been interests in a QFPA but for the non-resident contributions test.

The amended definitions are the "other income" and "net New Zealand superannuation" definitions.

Other income

Section JB 2 (1) imposes New Zealand superannuitant surcharge at the rate of 25% of the amount by which a superannuitant's *other income* in that income year exceeds his or her specified exemption.

Section JB 3 (1) and item "a"

The definition of other income in section JB 3 (1) has been amended by repealing item "a" of that definition and inserting a new item "a".

Paragraphs (i) and (ii) of item "a"

Domestic pensions and annuities are generally exempt from income tax in New Zealand, either under section CB 9 (f) (for annuities) or under section HH 3 (5) (for pensions). However, paragraph (i) of item "a" adds back one-half of those pensions or annuities for surcharge purposes.

Pensions or annuities received from a QFPA are fully assessable for income tax in New Zealand. Paragraph (ii) of item "a" therefore deducts one-half of these pensions or annuities from a superannuitant's other income.

Paragraphs (iii)(A) and (B) of item "a"

Paragraphs (iii)(A) and (B) are more complex and require additional explanation. These paragraphs were added to give the concessionary surcharge treatment to those pensions and annuities that are received from interests in foreign superannuation schemes and life insurance policies that meet both of these conditions:

- They are specifically excluded from the FIF regime.
- They do not meet the QFPA definition because the non-resident contributions test is not met.

The policy reason for extending the concessionary surcharge treatment to pensions and annuities received from these foreign entities relates to the key policy issues discussed in Part 1. That is, the QFPA measures are targeted at interests in foreign superannuation schemes or life insurance policies that, if removed from the FIF regime, would not undermine the FIF regime or New Zealand's life insurance and superannuation regimes.

People who receive pensions or annuities from interests in foreign superannuation schemes or life insurance policies that are specifically excluded from the FIF regime will be taxed on a cash basis in any event. However, a significant number of these people would not meet the non-resident contributions test, so they would have to pay surcharge on the whole pension or annuity from that interest.

Accordingly, it is appropriate that people with interests of this nature, such as New Zealand residents who meet the de-minimus test in section CG 15 (2)(d), should not be deprived of access to the concessional surcharge treatment.

Without paragraphs (iii)(A) and (B) of item "a", pensions and annuities received from such interests would be fully subject to surcharge, even though they would be assessed on a cash basis, in the same way as someone with an interest that is a QFPA. With the addition of paragraphs (iii)(A) and (B), people with interests of the type referred to in those paragraphs will now be charged surcharge on only one-half of their pensions and annuities.

Paragraph (iii)(A) refers to interests that are not treated as interests in a foreign investment fund because they are excluded by sections CG 15 (2) (d) (which relates to the $20,000 de minimus rule), section CG 15 2(e) (which relates to the exchange controls of foreign countries which prohibit a person from deriving any profit or disposing of their investment); and CG 15 (2)(f) (which relates to the new residents' exemption).

Paragraph (iii)(B) refers to those interests that would be a QFPA but for the fact that the non-resident contributions test in the definition of QFPA is not met.

Example 6

Ms Q, who has been resident in New Zealand since the age of five, has an interest in a life insurance policy which was taken out by her parents with a UK life insurer before the family emigrated to New Zealand. The contributions continued to be made until Ms Q's 21st birthday. Aggregate contributions made to the life insurer do not exceed $20,000. The interest is excluded from the FIF regime by section CG 15 (2)(d).

The policy matures and begins paying an annuity of NZD $2,000 a year. The interest in the life insurance policy is not a QFPA because contributions were made at a time when the recipient of the annuity was resident in New Zealand, and continued after the three to four year period of grace allowed in the QFPA definition.

The annuity payable in this example would be assessable on a receipts basis. Only one-half of the

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4 In sections CG 15 (2)(d) to (f).

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annuity will be subject to the surcharge because of paragraphs (iii)(A) and (B) of item (a) of the definition of "other income" in section JB 3 (1).

Net New Zealand Superannuation

The amount of surcharge a person is liable to pay in any income year cannot exceed the *net* amount of New Zealand Superannuation actually received in that income year. That is, the surcharge cannot exceed the after-tax amount of New Zealand Superannuation. In calculating net New Zealand Superannuation, the amount of the tax to be deducted is calculated by assuming the New Zealand Superannuation is the last amount of income earned for that year and had tax imposed at the highest marginal tax rate applicable to a person.

The formula used in the Act to determine net New Zealand Superannuation starts with the gross New Zealand Superannuation, then deducts an amount of tax that is represented by the difference between the tax that would be payable on the superannuitant's total income derived in that year and the tax that is payable on the "other income" and any foreign social security pension derived in that year.

Item "c" of the net New Zealand Superannuation formula therefore adjusts the "other income" amount to bring it back to what it would have been for income tax purposes. That is, it deducts one-half of any amount received from a domestic pension or annuity and adds one-half of the foreign pension or annuity. In essence, it represents the opposite of the treatment applied by item "a" of the "other income" definition.

Section JB 2 (3) and item "c"

The definition of net New Zealand Superannuation in section JB 2 (3) has been amended to accommodate the changes necessary as a result of the new QFPA rules, by repealing item "c" of that definition and inserting a new item "c".

Paragraphs (iii), (iv)(A) and (B) of item "c"

These paragraphs of item "c" contain the provisions necessary to deal with pensions or annuities received from any interest that is a QFPA or would be a QFPA but for the circumstances described in paragraphs (iv)(A) and (B). An understanding of these paragraphs is provided in the discussion on paragraphs (iii)(A) and (B) of the definition of "other income" above.

Foreign social security pensions

The entitlement to these pensions would not constitute an interest in a QFPA as they would not meet the definition of a foreign superannuation scheme. Any foreign social security pension received by a New Zealand resident is deducted from the amount of "other income" for surcharge purposes. These pensions, which are referred to as "specified social security pensions", are therefore not subject to surcharge.

Part 5 - General examples

Examples - QFPA definition met

Example 7

Ms P transfers to New Zealand from the USA as part of her job with a large multi-national company. She becomes resident in New Zealand in September 1996 and continues to make contributions to the scheme until 31 March 2000. She continues working in New Zealand until her retirement in 2010. At this time she receives her pension from her employer's USA superannuation scheme. The scheme cannot be assigned, surrendered or borrowed from.

This superannuation scheme meets the definition of an interest in a QFPA as all contributions were made to the scheme within the time allowed in the QFPA definition.

Example 8

Mr U, who emigrated to New Zealand to retire, has an interest in a foreign superannuation scheme which was established by an Act of Parliament in his country of origin. Contributions to this scheme were earnings-based and compulsory. Mr U has not made any contributions to this scheme since he began residing in New Zealand.

In this case, Mr U has an interest in a foreign entity as all contributions were made while he was non-resident. The QFPA definition is satisfied.

Examples - QFPA definition not met

Example 9

Mr F has an interest in a foreign life insurance policy. He became resident in New Zealand in December 1995, not having been resident in New Zealand previously. Mr F continues to make contributions to the foreign entity after 31 March 1999.

Mr F has not met the non-resident contributions test in the QFPA definition. He will be deemed to acquire an interest in a FIF on 1 April 1999, being the day following the last day of the new resident exemption in section CG 15 (2)(f).

Example 10

Ms J has an interest in a foreign life insurance policy. She stopped contributing to the fund on becoming resident in New Zealand.

Her policy document allows her to withdraw limited amounts of money from the policy before its maturity date. The future benefits of the policy will be reduced to take the interim withdrawal into account, but not by an amount that is substantially more than the amount withdrawn.

In this case the QFPA definition is not met because of the operation of paragraph (c) of that definition. The interest in the life insurance policy will become an interest in a FIF after the new resident exemption in CG 15 (2)(f) expires.

Example 11

Ms Z has been a New Zealand resident since birth. She works in New Zealand for an employer based in the United States. The employer requires all employees to contribute to their superannuation scheme, which is also based in the United States.

Ms Z will not have an interest that is a QFPA as all contributions were made while she was resident in New Zealand. In this case she will have an interest in a FIF since the later of the beginning of the FIF regime or the date she began contributing to her employer's superannuation scheme.

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Foreign-sourced pensions: detailed analysis of tax treatment

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