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Investment Income Information
C/- Deputy Commissioner, Policy and Strategy
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Dear Sir

KPMG submission — Investment Income Information

KPMG is pleased to make a submission on the Government Discussion Document "Making Tax Simpler: Investment Income Information" ("the Document").

The Document proposes more frequent and wider reporting to Inland Revenue of investment income and investor details to allow matching of income, tax withheld and investors. This requirement will be supported by use of a non-declaration rate.

We understand that the aim is to better deliver income tax and social policy obligations and entitlements. We also understand that the decision on what is reported should not limit future policy options.

We agree that better information provided to Inland Revenue is an appropriate goal. However, we expect that the range of information to be reported and its frequency will impose additional costs.

The proposals will affect not just financial institutions such as banks and insurers. It will affect funds and fund managers, custodians and agents, Maori Authorities as well any payer of interest and dividends no matter what their business. We use "Investment Income Reporters" as a general term for those affected. We refer to specific parties affected where relevant.

Costs may not fall equally on Investment Income Reporters. For example, SMEs are likely to be disproportionately impacted if they do not have current Inland Revenue reporting obligations and therefore capable systems.

We are not convinced that the Document has clearly made the argument in favour of this trade-off.

We consider that Investment Income Reporters are better placed to assess the costs and problems associated with the proposals. Our submissions therefore focus on key principles and concerns.

We have not answered all of the questions in the Document.

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Transparency of approach and system constraints

In various discussions on the proposals, two different approaches have been evident. Some have assumed that the proposals would be implemented by modifications to existing returns and therefore reporting and processes. Others have assumed that new forms, returns and processes would be implemented.

The Taxation (Business Tax, Exchange of Information, and Remedial Matters) Bill proposes a number of changes as a result of differences between FIRST and START. These imply that START will not be as constrained as FIRST. However, it appears that START does have some constraints.

As far as we are aware, Inland Revenue has not published its approach to considering the proposals or the broad system design and constraints for START.

This makes it difficult to focus our submissions or to assess alternatives (some of which are discussed below).

Submission points

We submit that:

- The Government should confirm that it is assuming that alternatives to current systems, forms, returns and processes may be used to implement the Business Transformation ("BT") proposals; and
- Inland Revenue should publish details of START and any constraints that it has.

A three-way relationship for matching – use of non-declaration rates for compliance

Correctly taxing investment income involves investors, Investment Income Reporters and Inland Revenue. The investment income proposals shift the cost and onus to Investment Income Reporters.

This is particularly true of the non-declaration rate proposal. They shift the policing of the use of IRD numbers from investors and Inland Revenue to Investment Income Reporters.

The Document does not make it clear why alternatives which place the onus on investors or Inland Revenue have been discounted. In our view, the responsibility for policing IRD numbers should be with Inland Revenue and for their provision should be with investors.

We consider the allocation of responsibility between the three parties is unbalanced.

Submission points

We submit that consideration should be given to:

- Inland Revenue using the information provided by the proposals and taxpayer confirmation of income to require investors to provide IRD numbers – i.e. undertaking appropriate enforcement action;

- Inland Revenue providing the IRD number directly to the Investment Income Reporter based on matching investor details received. (A form of matching is currently used to correct PIE tax rates); or
- Requiring that IRD numbers are provided to an Investment Income Reporter before an account which generates reportable investment income can be used to transact by an investor.

  This is the effect of the approach being proposed for self-certification for Automatic Exchange of Information ("AEOI") purposes in the Taxation (Business Transformation, Exchange of Information, and Remedial Matters) Bill. If this approach is taken, this rule should apply only to new accounts. Existing accounts should be subject to Inland Revenue action.

  We assume that foreign persons will not be required to have an operational bank account to receive an IRD number. Phase 2 AML should be in place by the time the proposals commence. Otherwise, Investment Income Reporters and Inland Revenue will need two different systems. If the bank account requirements do not change, this would be a problem as the operational bank account requirement applies to resident entities controlled by non-residents.

We suggest this alternative approach because a non-declaration rate does have its own difficulties (see the PIE comments below for an example).

Meeting the objectives

More frequent reporting by Investment Income Reporters is aimed at:

- Better management of tax and social policy obligations and entitlements;
- Better forecasting.

The Document does not detail how Inland Revenue will implement real-time adjustments to taxpayer's positions.

Better management

There will be problems from the very nature of the data.

For example, PIE income can be volatile due to the nature of the underlying investments. A year-to-date income position can turn to a loss and vice versa.

This has potential to cause continuous adjustments during the year. Social policy delivery throughout the year may be "lumpy" (i.e. entitlements and obligations will vary from month to month). We do not believe this is ultimately what is intended for the proposals.

Although the electronic provision of investment income information should make it easier to match income and tax paid with taxpayers, it is likely that it will still require a significant number of people to make real-time adjustments.

If the approach is to automate adjustments, Inland Revenue will need to have people available to respond to queries and complaints and to take corrective action where necessary. If the approach is to review automated adjustments before they are made, that will also take people resource.

Given Inland Revenue's announcements that it expects to be "leaner" after BT, it is not clear that it will have sufficient resource to action real-time monthly or more regular than annual adjustments.

Further, on current law, some investment income does not have current year tax and social policy effects. For example, PIE income from KiwiSaver investments is currently excluded if the correct PIE tax rate has been elected. The Document suggests more frequent than annual reporting may not be required. We agree. This is a pragmatic solution.

Further, the assumptions supporting the benefit of monthly reporting of investment income needs to be tested. Inland Revenue's late 1990's estimates, at the time of the non-filing changes, were the vast majority of interest earners had less than $200 of annual interest. (This was one of the reasons for the current $200 "tax not correctly withheld" income de minimis for filing a tax return).

It is likely that the vast majority will have only nominal interest income. Monthly reporting of this income will impose costs disproportionate to any benefit from more accurate delivery of social policy.

Further, there is no apparent calculation of the additional compliance costs for the hundreds of thousands of SME companies to report shareholder dividend information when dividends are paid. We would expect this to outweigh any estimated benefit from greater social policy accuracy. It would be helpful for this to be explicitly stated, so that submitters can better understand the trade-offs.

Submission points

We consider Inland Revenue's ability to implement real-time adjustments needs to be confirmed and publicised, before the costs of monthly (or more regular than annual) investor and investment income reporting are imposed.

Further, we believe careful consideration is required of the impact more regular investment income reporting will actually have on social policy delivery. It is unclear there will be a material improvement in accuracy or whether costs will be imposed for little benefit.

Better tax forecasting

Inevitably, the data provided to Inland Revenue will not be perfect. It will be difficult to provide forecasts of PIE tax payable. Further, particularly with PIE income, the same income may be reported multiple times.

An investor in a PIE will invest in a retail PIE. That PIE may in turn invest, through one or more wholesale PIEs, in the underlying investments. The PIE income will be reported at least

twice. If the investor invests through a PIE proxy (custodian), a further layer of investor reporting will occur.

Submission points

We believe the above highlights the need to practically limit any increase in the frequency of investor reporting to the level of the ultimate "retail" investor. That is, wholesale PIEs and other wholesale Investment Income Reporters should be removed from the requirement for more frequent reporting. They are not the intended target. This would also help with greater accuracy of tax forecasting.

Inland Revenue will need to be aware of and to adjust for the limitations of reporting to be able to produce reasonable tax forecasts.

Know Your Client ("KYC") tax rules

Financial Institutions particularly are subject to Anti-Money Laundering ("AML") and other rules which require them to know who their client is. Those rules do not typically impose tax related KYC requirements. However the US Foreign Account Tax Compliance Act ("FATCA") and AEOI do and will impose such requirements for non-residents and non-resident controlled accounts.

We consider the tax status of an investor to be implicit in current processes. A resident will be subject to RWT and PIE tax. A non-resident will be subject to NRWT and Approved Issuer Levy ("AIL") and reduced PIE tax rates in certain cases.

Applying these rules assumes some knowledge of the tax status of the customer. We acknowledge that historically this may have been through rules of thumb (for example, a foreign address to apply the relevant double tax agreement.)

The investment income and AEOI proposals provide an opportunity to consider on what basis an Investment Income Reporter can decide that resident or non-resident tax treatment applies.

It also provides an opportunity to consider what an investor must provide to be subject to one tax type or rate rather than another. For example, many jurisdictions impose a higher rate of NRWT if an investor does not provide documentary evidence of their residency.

Any changes to qualifying criteria should consider how, if and when existing accounts would be subject to the new rules.

Submission points

We consider:

- A clear set of rules which allow an Investment Income Reporter to safely apply resident or non-resident tax types and rates should be considered; and
- This should take into account the requirements for FATCA and AEOI so that any duplication is minimised.

Overlap of tax and regulatory reporting

The investment income proposals do not appear to take into account the AEOI proposals. For non-residents and non-resident controlled accounts, much of what is being requested will be reported under AEOI or FATCA.

Financial institutions also report to regulatory agencies and to investors as a result of regulation and good client relationship practice. (See the custodian comments below as examples.)

This means that the same information is being reported multiple times to Inland Revenue and to Government already.

Submission points

We submit that consideration should be given to:

- Reducing duplicate investor reporting and/or the need for the investment income reporting proposals; and
- Standardising, even if multiple reporting is still considered necessary, across Government the information and format of information reporting

before any final decisions are made on the proposals.

Use of existing reporting and processes

The proposals will impose a cost on a wide range of Investment Income Reporters. We have considered alternatives to current tax returns and the way in which information is provided in those returns to reduce that cost.

Our view is that the cost of the proposals can be reduced if reporting to Inland Revenue can use existing reports modified as little as possible. We present two examples.

1 Custodians and WRAP platforms (which tend to be PIE proxies) already produce detailed reports to investors. These are reports to comply with custodian regulatory requirements ("custody reports") and to allow their investor clients to comply with their tax obligations ("tax reports"). These reports may already contain the information needed by Inland Revenue. Aligning the investment income reporting requirements with those reports may reduce the cost of implementing the proposals. Eliminating the requirement for separate reports may also reduce the costs imposed by Government.

2 PIEs provide pricing files formatted to an agreed specification to other PIEs and report in a prescribed format to investors. These existing reports will contain much of the information required in the Document but some modification is likely to be required.

We have not confirmed that this is possible, but using these existing reporting mechanisms may allow a lower cost implementation. There are likely to be other examples.

Submission points

We consider Government should engage with financial institutions to determine whether existing processes and reporting can be used as a base to reduce the cost of implementing the proposals.

PIEs

The PIE regime has been deliberately constructed. It requires, for most PIEs, a daily calculation of taxable income so that it can be attributed to investors at the time. The trade-off is there are certain income tax rules which are streamlined and that tax is payable on certain events (exit or at PIE period end, usually annually but it may be more frequently.)

The aim is to allow PIE income to a particular date to be calculated. PIE tax, which would be payable on a particular date should an investor exit, can also be calculated. However, PIE tax on exit is generally not likely to be routinely stored or reported in real-time. The actual PIE tax calculations, which are processed at quarter or year-end can take days to complete. (This obviously depends on the number of investors and the sophistication of PIE systems.)

We believe that more regular (e.g. monthly) reporting of PIE income will impose additional costs for PIEs. This is especially so if current systems do not routinely track and store PIE income and tax calculations. Further, given the volatility of PIE income, using this as a base for adjusting social policy outcomes and forecasting future tax is difficult and likely to be misleading.

Submission points

- We consider that annual reporting should be retained for PIE income. At a minimum, we agree that this should be the case with "locked-in" PIE funds as there will be limited tax and non-tax consequences.
- Bringing forward the yearly reporting requirement to 30 April (from 31 May or 30 June) may give rise to technical issues for PIEs.
- The proposals for reporting investment income (and tax paid) on joint investments needs to pay particular attention to the potential impact for PIEs'. Administrative concessions were agreed for recording and reporting joint PIE investments. Their removal may have significant implications for PIE providers.
- The non-declaration rate proposals for PIEs also need to be considered with care. This raises two concerns. Firstly, the cost to implement the proposed new 45% non-declaration rate may be substantial. Secondly, any inability to use the non-declaration rate tax as a credit, either for income tax or social policy obligations, will affect the integrity of the PIE system. The rate will be significantly higher than the top marginal tax rate.

Intermediaries

The New Zealand tax system relies on intermediaries such as custodians. Withholding tax and reporting is already an integral part of the system.

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However, for this system to work efficiently, a custodian will place reliance on another intermediary's systems and processes for the tax status of investors.

This means that an intermediary may not be able to match tax paid with an underlying investor.

We understand that Inland Revenue expects that an intermediary will report another intermediary as the recipient of income if it receives the income for another person. Inland Revenue can place reliance on information for New Zealand residents reported through AEOI to it.

This expectation is not in the Document. It should be confirmed.

Further, our experience is that an intermediary's obligations and its ability to rely on information provided to it is not clear under the tax rules. There is a combination of tax rules, accepted practice and agreements with Inland Revenue and others. This means that an intermediary's obligations are not transparent. There is an opportunity to establish or confirm good practice for intermediaries so that they can be comfortable they are complying.

Submission points

We consider that clear rules for intermediaries should be developed.

Other issues

We comment briefly below on a number of other issues raised in the Document:

Information on AIL recipients – we expect this information to be provided through the AEOI rules. There is no driver for further or separate reporting. If this proposal proceeds, the currently proposed limit to the availability of AIL may not be needed. The proposal should provide Inland Revenue with sufficient information on AIL recipients to undertake enforcement action.

Date of birth information – we recognise the benefit of this indicia as a matching mechanism for Inland Revenue. However, this needs to be weighed against the additional cost for Investment Income Reporters incorporating this data field and the privacy concerns from its use as an identifier.

Error correction – we strongly support self-correction of errors in subsequent periods.

We are concerned that thresholds will be set too low. This is particularly so as withholding taxes are not generally final taxes.

Further, errors are likely to be those made by investors or investors will have the income gross of tax. This suggests the onus for correction should be on investors.

In principle, we also consider that more frequent reporting and its costs should be factored into the trade-off for requiring a correct period return. This is particularly the case where errors are process and system errors and where information provided is subsequently corrected.

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Inland Revenue needs to articulate the concerns which have led to the Document essentially following current law. This will allow a better consideration of the trade-offs and allow solutions to be developed to meet those concerns.

Certificate of exemption database – we support Inland Revenue maintaining a database of exemption certificates for Investment Income Reporters to rely on. However, the onus should be on exemption certificate holders to advise Investment Income Reporters and for Inland Revenue to ensure the database is up to date.

End-of-year tax certificates – We support in principle removing the requirement to provide a year-end tax certificate. However, this is unlikely to reduce costs significantly. Investors may still request this information as a "cross-check" against the information reported to Inland Revenue. Further, many Investment Income Reporters will provide year-end information either from a customer relationship management perspective or because of regulatory requirements.

Transition – appropriate transitional requirements will need to be considered. A number of our submissions could be implemented over time rather than requiring an immediate start. For example, investor provision of IRD numbers could be required as they interact with the Investment Income Reporters rather than being a separate exercise. Further, lessons may be able to be learnt from the implementation of AEOI.

Investors

Our focus has been on Investment Income Reporters because we consider the proposals have an over focus on them. Investors will be affected by the proposals and any changes made to them.

Their perspective needs to be considered. Inland Revenue should be prepared to consult as modifications are made. Further, when decisions are made Inland Revenue should communicate to investors the changes, why the changes are being made and what they are required to do. This will be important for the success of the proposals.

Summary

We have highlighted a number of concerns with the proposals. We have also highlighted some opportunities.

We are not in a position to confirm which opportunities can be taken and which concerns will impose material and significant costs.

We consider Inland Revenue should work with Investment Income Reporter affected by the proposals to confirm the reality of the concerns and the opportunities. However, it will first need to clearly state its approach and any system constraints.

Importantly, the appropriate allocation of responsibilities and actions for investors, Inland Revenue and investment income payers need to be confirmed.

Next steps

We consider that further consultation will be required before the requirements for investment income reporting are finalised. Time should be allowed for this to occur.

Further information

If you would like to discuss our submission please contact us – John Cantin, on 04 816 4518, and we would be happy cover any points raised in greater detail.

Yours sincerely

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