Public Interest Law Journal of New Zealand

(2024) 11 PILJNZ 69

ARTICLE

The PIE Regime: A Failure to Address Horizontal Inequity?

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When tax distortions exist, they drive investment decisions. These circumstances, known as horizontal inequity, create inefficiencies and hamper economic growth. The Government introduced the portfolio investment entity (PIE) regime in 2007 to address some of the more egregious distortions that existed then. PIEs have become the primary vehicle used for collective investment in New Zealand. While the changes removed significant distortions of the time, they created further distortions which remain unresolved, such as opportunities for undesirable tax planning, the discouragement of share ownership in favour of other asset classes, and a lack of incentives for lower-income investors to invest. This article argues that the PIE regime strongly contributes to New Zealand's low savings rates and focus on unproductive investment. It suggests changes to correct the PIE regime's design mistakes. It recommends full or partial alignment of PIE rates to personal rates to increase horizontal equity and encourage savings. It also recommends changes to how shares are taxed so that managed funds can become more attractive investments.

I Introduction

When individuals invest, they make two choices: what to invest in, and how to structure the investment. They often decide what to invest in based on expected return, risk tolerance and time horizon. Investment structuring might be determined by the desired level of control, flexibility in structure or administrative cost. Both of these choices are also heavily influenced by tax.

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Tax influences behaviour in an unhealthy manner as it changes investment decisions regardless of whether there are changes to the underlying assets. This distortion is inefficient as investors allocate funds purely for tax reasons, resulting in suboptimal investment. Creators of tax systems are aware of this inefficiency. They generally try to create systems that treat different investments and different investment vehicles as equally as possible. A tax system that meets this goal is said to have achieved horizontal equity: investors are taxed based on their investment income rather than the nature or structure of their investments.

In 2004, the New Zealand tax system was far from achieving horizontal equity. It contained several tax distortions which influenced investor behaviour. High-income investors could use vehicles to reduce their tax liability, while lower-income investors often paid tax at higher rates than their personal rates. Investment vehicles spent excessive resources structuring themselves to fall on the correct side of complex income tests, which posed no problem for direct investors. Investments sat on an uneven playing field, with property (being residential real property) and some overseas shares hardly being taxed. Domestic shares, and investments in countries out of favour, were taxed at much higher rates. These distortions were inequitable and restrained the growth of the economy.

The Government created the portfolio investment entity (PIE) regime to move towards horizontal equity. The PIE would be the primary vehicle used for collective investment. Investors in PIEs would be taxed similarly to if they invested directly. The entity would receive tax concessions and follow clear and straightforward rules. Investments would be taxed equally, encouraging the PIE to build a diverse portfolio and make it available to all investors. Tax distortions would be substantially removed and investment would be productive, equitable and beneficial to society. The PIE regime would go hand-in-hand with the Government's flagship project of the time: a private retirement savings scheme called KiwiSaver. Horizontal equity would be restored as all investors would have access to quality investments without inconsistent tax obligations.

Nearly 20 years since the conception of the PIE regime, it is worth standing back and assessing the state of savings and investment in New Zealand. Have the changes achieved the goals the Government had in mind? Certainly, the PIE has deservedly become the preferred entity for collective investment vehicles (CIVs), and KiwiSaver is widely popular. However, a lopsided tax concession has ensured that high-income investors are treated preferentially when using PIEs, while lower-income investors have little reason to choose PIEs. The changes removed some distortions, but created others that have resulted in constrained levels of collective investment. Although the PIE regime has partially succeeded in addressing previous inequities, it has failed to develop the improvement in savings culture it promised and productive investment remains well below its potential.

A complete overhaul of the PIE regime is not necessary. The PIE tax rules solve much of the administrative difficulty previously faced by CIVs and are difficult to abuse. On the other hand, small changes to the PIE regime could help ensure that its original goals are met. The Government should consider either a complete removal of the tax concession being provided to PIE investors, or a redistribution of the concession to ensure all investors benefit equally. The Government should reduce the excessive tax rate levied on foreign shares and bring them in line with domestic investments. A combination of these changes could result in substantial improvements to New Zealand's investment quality without significant fiscal cost to the taxpayer.

This article questions the current effectiveness of the PIE regime in attaining the goals it set out to achieve. Part II of this article provides a brief overview of the PIE regime and the context in which it was created. Part III then identifies the problems the PIE regime attempted to solve and the principles its design was based upon. It will then measure the extent to which these goals have been achieved. Part IV suggests changes that may align the regime more closely to its original goals. Part V concludes.

II Background and the Creation of the PIE Regime

Companies and trusts are familiar entities used for investment in New Zealand.[1] These entities are taxed separately at the entity level without regard to their investors. Investors then carry separate obligations concerning distributions they receive from the entity.[2] When a company receives income, it pays tax at a flat corporate rate. When the company distributes this income, the investor must either pay further tax or have a tax credit to offset against other income. This is based on whether their personal tax rate is higher or lower than the corporate rate. Similarly, when a trust receives income, it may distribute or accumulate it. If it distributes the income, the investor must pay tax on this income at their personal rate. If the trust accumulates the income, it pays tax at a flat rate. It can then be distributed tax-free at a later date. In both cases, the structure is convenient for the entity. Its tax rate is constant regardless of its investor base, and it bears no responsibility to ensure its investors pay the correct amount of tax on their distributions.[3]

An alternative method for taxing investments is on a look-through basis. A partnership is a typical example of this method. Although the entity usually files a tax return, this is purely informational to assist the Inland Revenue Department (IRD).[4] Any income from the entity flows through the entity entirely, with the entity paying no tax. The income is attributed to its investors according to their ownership proportion, and the investors bear full tax liability.[5]

Neither method of taxation is ideal for CIVs. CIVs usually pool money from many individual investors and are professionally managed.[6] As these entities become more widely held, this becomes problematic for the IRD. Many additional investors need to file tax returns, creating a hefty administrative burden. In addition, investors on different incomes face disparate treatment due to the fixed corporate rate, which applies despite their personal rate.

A portfolio investment entity, or PIE, is the main type of CIV. A PIE is a company or fund that invests on behalf of investors, meets the relevant requirements and opts to become a PIE.[7] Before the creation of the PIE regime, collective investments would be made either on an entity basis or a look-through basis. The PIE regime created a unique mechanism. It focused on solving the difficulty of appropriately taxing widely held investments. The mechanism combines the two methods of taxation by placing tax liability primarily within

1 See generally Tax Working Group Secretariat *Appendix 1: Types of business entities in New Zealand and how they are taxed—Background Paper for Sessions 6 and 7 of the Tax Working Group* (March 2018) for an overview of how taxation methods vary by entity.

2 At 4.

3 See generally Tax Working Group Secretariat, above n 1.

4 Inland Revenue *Partnership and look-through company (LTC) return guide 2024* (March 2024) at 4–5.

5 See generally Tax Working Group Secretariat, above n 1.

6 Tax Working Group Secretariat *Managed funds and retirement savings: Position Paper for Session 21 of the Tax Working Group* (26 October 2018) at [4]. There is no distinction between “managed funds” and CIVs for the purposes of this article.

7 Income Tax Act 2007, s HM 2.

the entity rather than the investors. However, it ensures that tax liability is calculated according to the personal rates of the investors rather than at a flat corporate rate.

This Part will briefly explore how tax affects investment before outlining the context and history of CIV taxation and finally providing an overview of the PIE regime currently governing CIV taxation.

A *The effect of tax on investment*

When saving money, individuals and households must choose how to best allocate their funds through investment. There are limitless investment options. Investors also consider several factors when deciding where to put their money—expected returns, risk levels, time horizons—but tax pervades them all.

This is particularly relevant in New Zealand, which has no general capital gains tax and does not tax all investments equally. One common example of this is investors choosing property, motivated by tax-free capital gains, rather than financial assets. Financial assets are subject to broader taxes on returns.[8] An investor with two assets—taxed differently but otherwise equivalent—will invariably prefer the tax-advantaged option.

Tax systems are generally designed to minimise the impact of tax on behaviour. New Zealand claims to have a "broad-base, low-rate" tax system.[9] Such a system attempts to apply a low tax rate to as many forms of income as possible to reduce any potential distortions of investment decision-making.[10] Achieving equal tax treatment between all investment options is likely impossible, although it remains a worthy goal as it aims to increase efficiency.[11]

Accordingly, where tax influences the behaviour of investors, it creates costs to society. Investors arrange their affairs not to yield the benefits of different assets or structures, but to minimise their tax liability.[12] Capital therefore flows to where tax savings can be found, rather than where it would most benefit society. New Zealand is not immune to this. As a former Associate Minister of Finance has stated: "it is disheartening to hear how often tax advice is the critical factor directing New Zealand's scarce investment resources".[13]

B *Former tax treatment of CIVs*

Before the PIE regime was introduced, three key distortions applied to collective investments. Tax treatment differed between (1) investors based on their vehicle, (2) investors based on their personal rate, and (3) investments based on their country of origin.

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8 Janice Burns and Maire Dwyer *Households' attitudes to saving, investment and wealth* (Reserve Bank of New Zealand, Bulletin 70(4), December 2007) at 29–31.

9 Tax Working Group Secretariat *Taxation of capital income and wealth: Background Paper for Session 5 of the Tax Working Group* (March 2018) at [17].

10 At [17]. This claim should be doubted due to the absence of a capital gains tax among other distortions which are discussed in this article.

11 At [17].

12 New Zealand Treasury *Estimating the Distortionary Costs of Income Taxation in New Zealand: Background paper for Session 5 of the Victoria University of Wellington Tax Working Group* (October 2009) at 1.

13 David Cunliffe, Associate Minister of Finance "A Vision for the Future of the Investment and Savings Industry" (address to Fundsource Professional Investment and Savings Conference, Auckland, 19 March 2005).

First, investors faced a disparity in tax treatment based on whether they invested through an investment vehicle.[14] Investors could structure their investments by holding them directly or investing in a CIV.[15] An individual investing directly was generally considered to hold the investments on capital account. While the investor would pay tax at their personal rate, the tax would only be paid on income derived from the investments, such as dividends and interest, rather than capital gains.

However, if the individual decided to use a collective vehicle, such as a unit trust or superannuation scheme, they would receive unfavourable tax treatment. The investments made by CIVs were generally considered to be held on revenue account as the vehicle was in the business of investing. This meant the CIV—and ultimately the individual—would be liable for tax on realised gains, in addition to dividends. This was despite the individual likely holding their investment in the CIV on capital account. This distortion encouraged investors to invest directly rather than through a CIV.

Secondly, CIVs would typically pay a flat tax on profits earned before allocation or distribution to the investors.[16] Lower-income investors would have their investment income taxed at a higher rate than their other income.[17] High-income investors were under-taxed on their investments. This distortion meant CIVs encouraged high-income investors and disincentivised lower-income investors.

Finally, investors could invest in "grey list" CIVs from certain countries, resulting in no tax being paid at the entity level.[18] For example, a New Zealand investor investing in a United Kingdom CIV would pay no United Kingdom tax on their gains and would only pay tax on dividends received. These CIVs would often be deliberately structured to accumulate dividends rather than to distribute them. The CIVs could then invest globally, allowing the New Zealand investor to avoid paying foreign investment fund (FIF) tax even if the underlying investment was not on the grey list. This made New Zealand CIVs and New Zealand investments less attractive to investors.

The result was that investors could substantially improve their returns on the same investments by carefully structuring their holdings based on their personal rate and ability to obtain the investment directly. Empirical evidence suggested that, for a high-income investor, ensuring that the investment was held on capital account was more important than the direct tax saving by holding the investment in a CIV.[19] These distortions were thought to be hindering the New Zealand economy.[20]

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14 See Craig Stobo *Towards Consensus on the Taxation of Investment Income: Report to the Minister of Finance and Revenue* (29 October 2004) at 2–4 for background on the capital-revenue boundary as it applies to investments.

15 At 35.

16 At 41–44 for background on the tax treatment of different investment entities.

17 This article frequently distinguishes between "high-income" and "lower-income" investors. This is a reference to the level of taxable income an investor receives, with "high-income" investors being those on the highest personal rate, and "lower-income" investors being all other investors. These references do not necessarily correspond with the socioeconomic status of the investor.

18 See Stobo, above n 14, at 9–12.

19 At 5.

20 At 39.

C *Stobo Report*

In the early 2000s, the New Zealand economy was in an odd position. The country was rapidly growing and had low inflation and unemployment.[21] At the same time, household debt was skyrocketing, with the financing largely coming from offshore.[22] Membership amongst superannuation schemes had declined to below 15 per cent of the workforce.[23] CIV investment was low.[24] The Government considered that there was a chronic savings problem across the country and sought methods to address it.[25]

One notable cause for the low savings rates was that primary retirement savings products—superannuation funds and unit trusts—were tax-disadvantaged relative to other forms of investment.[26] Even where money was invested in these products, the tax system did not incentivise investment in productive assets, instead favouring unproductive investments such as property.[27]

The Government, therefore, proposed a broad review of the tax system's application to investments as part of a broader measure to incentivise work-based saving.[28] The Government considered that it could best encourage savings when tax rules were neutral between different investments.[29]

The Government appointed Craig Stobo, a former fund manager, to consult on options to reform investment tax rules.[30] The resulting report *Towards Consensus on the Taxation of Investment Income*—known as the *Stobo Report*—was tasked with levelling the playing field for investors, particularly concerning the tax disadvantages of CIVs.[31]

The Government ultimately considered that good tax policy was conducive to New Zealand firms accessing capital freely and, by extension, ensuring the tax system enabled growth and innovation.[32] The *Stobo Report* was required to propose changes that, as far as possible, protected the tax base, minimised disadvantages faced by lower-income investors, and minimised compliance costs.[33] The Government was amenable to sacrificing tax revenue to achieve effective reform.[34]

Stobo considered that inconsistent tax treatment of investment created several unintended consequences. The capital/revenue boundary created artificial demand towards passive investments and away from active investments.[35] CIVs were undergoing

21 Michael Cullen, Minister of Finance "NZ's Path to Growth" (speech to Hamilton Club, Hamilton, 15 July 2004).
22 Alan Bollard, Governor of the Reserve Bank of New Zealand "Investing in a low inflation world" (speech to the Auckland Club and the MBA Business Meeting, Auckland, 14 October 2003).
23 Savings Product Working Group *A Future for Work-Based Savings in New Zealand: Final Report* (31 August 2004) at 24.
24 Stobo, above n 14, at 9.
25 Michael Cullen "Public submissions invited on workplace savings" (press release, 16 September 2004).
26 Cullen, above n 25.
27 David Cunliffe, Associate Minister of Finance "Retirement income adequacy" (address to the Association of Superannuation Funds of NZ, Auckland, 31 August 2004).
28 Michael Cullen, Minister of Revenue "Speech to Institute of Chartered Accountants Conference" (Christchurch, 15 October 2004).
29 Cullen, above n 28.
30 Michael Cullen "Chair to consult on taxation of investment income" (press release, 7 July 2004).
31 Stobo, above n 14, at 35.
32 Cullen, above n 28.
33 Stobo, above n 14, at 36.
34 Cullen, above n 28.
35 Stobo, above n 14, at 8.

excessive structuring to avoid the tax disadvantages of being an investment vehicle, which created substantial compliance costs.[36] This structuring was harmful to collective investment and disproportionately affected lower-income investors.[37]

The Report considered that investors should be taxed based on their investments instead of their choice of vehicle.[38] The allocation of investment funds had become suboptimal and inefficient—tax was distorting where investors were putting their money. This was hurting New Zealand's growth.[39]

Stobo proposed several options for how investments could be taxed. These were implemented to varying degrees.

The Report's flagship recommendation was an Investment and Savings Tax (IST) for domestic and foreign investments.[40] The IRD would set a rate each year, which would be applied to the value of the investor's portfolio to calculate their taxable income for the year.[41] Stobo considered that this recommendation would shift the New Zealand tax system towards fully capturing economic income.[42] The Government abruptly dismissed the IST suggestion.[43] Commentators suggested several reasons for the decision.[44]

Alternatively, the Report suggested that capital gains on domestic shares held in a CIV should be tax-free.[45] This would make the capital/revenue boundary redundant and allow the CIV to hold and trade shares without fear of them being held on revenue account. The change had political support before the Report's release and was popular amongst stakeholders, becoming a straightforward change for the Government.[46]

Stobo and stakeholders also successfully[47] advocated for abolishing the grey list due to the disparities it created amongst investments from different countries.[48]

Stobo suggested a range of mechanisms for how CIV taxation could operate.[49] The main choices were whether tax should be levied at the entity level or on a look-through basis, and whether tax should be paid at a fixed corporate rate or variable rates based on the investor. The mechanisms broadly presented a clash between investor equity and administrative costs faced by the CIV. For example, one option provided administrative simplicity by having a single proxy rate levied on the income of the CIV.[50] However, this would have created timing advantages for high-income investors, where they temporarily pay too little tax. Similar disadvantages would accrue to lower-income investors, who would temporarily pay too much tax. While the disparity would be corrected at the end of the year, a high-income investor, for example, would receive the benefit of having

36 At 8.
37 At 8.
38 At 6.
39 At 5.
40 At 28.
41 At 16.
42 At 16.
43 Michael Cullen "Tax changes for low income and small investors" (press release, 20 May 2005).
44 Good Returns "Reaction to Stobo report" (17 November 2004) <www.goodreturns.co.nz>.
45 Stobo, above n 14, at 19.
46 Michael Cullen *Taxation of investment income; The treatment of collective investment vehicles and offshore portfolio investments in shares – A government discussion document* (Inland Revenue, June 2005) at [2.31].
47 Inland Revenue "Technical amendments to the offshore portfolio share investment rules" (2007) Tax Technical <www.taxtechnical.ird.govt.nz>.
48 Stobo, above n 14, at 26–28.
49 At 15.
50 At 22. This was Option 1(a).

additional funds until the liability became due. Another option would be to have the CIV apply a withholding tax to its income based on the variable rate of the investor.[51] Any inequity faced by investors due to temporarily paying the wrong amount of tax would be removed. However, the CIV would face the burden of applying various rates to many investors.

The eventual PIE regime imposed a hybrid of these options in which the CIV is primarily responsible for paying tax on behalf of investors, but with reference to the personal rates of its investors.

D *The PIE regime*

The PIE regime came into effect on 1 October 2007.[52] A CIV that does not qualify as a PIE or elects not to become one will be taxed according to the usual rules for the relevant entity.

The most common and relevant form of PIE is the multi-rate PIE.[53] A multi-rate PIE may be a company, superannuation fund or an unlisted group investment fund.[54] A PIE is not a separate legal entity.[55]

An investor in a multi-rate PIE must calculate and advise the PIE of their prescribed investor rate (PIR).[56] This is simple to calculate since it is directly tied to the investor's personal rate.

A multi-rate PIE calculates its pre-tax income, attributes this income to each investor, and calculates the tax liability of the PIE by reference to the attributed income and the PIR of each investor. This places the PIE in a similar tax position to the investors in the aggregate had they made the same investments directly. It will typically calculate the tax liability of each investor in each investor class for each day and then aggregate these liabilities into periods and classes.[57] The PIE is then responsible for meeting the tax liability on behalf of its investors. In addition, the PIE is regularly required to provide information to investors and the IRD.[58]

A CIV must meet several requirements to become a multi-rate PIE.[59] It must have at least 20 non-associated investors per class,[60] no investor may hold more than 20 per cent of the class[61] and investors must be given equal rights to income from the fund investments.[62] The multi-rate PIE must predominantly invest in land, shares or debt,[63] and source most of its income from these assets.[64]

The PIE enjoys a tax advantage over individuals and other entities through concessions when actively investing. It can trade New Zealand and most Australian shares freely and

51 At 23. This was Option 1(b).
52 Taxation (Savings Investment and Miscellaneous Provisions) Act 2006, s 2(22).
53 PIEs may also take the form of a listed PIE, a benefit fund PIE, a life fund PIE, or a foreign investment PIE.
54 Income Tax Act, s YA 1 definition of "multi-rate PIE".
55 Tax Working Group Secretariat, above n 9, at [16].
56 Income Tax Act, s HM 32(1).
57 Section HM 47(3).
58 Tax Administration Act 1994, s 25J.
59 See Income Tax Act, ss HM 8–HM 20 and HM 24–HM 30.
60 Section HM 14.
61 Section HM 15.
62 Section HM 17.
63 Section HM 11.
64 Section HM 13.

pay tax only on dividends, while an active trader would likely be taxed on all gains.[65] The PIE is subject to the same FIF regime as any other person. Therefore, overseas share investments will be subject to a yearly value-based tax regardless of trading activity.[66] The position becomes less clear concerning other active investments the PIE may make. Debt instruments likely do not carry the same danger as shares of being considered to be held on revenue account due to their income-focused nature.[67] If the PIE seeks to develop land, profits upon disposal will likely be considered income. However, many rules ensure that any person developing land will be taxed on their profits.[68] PIEs can almost completely disregard the complex capital/revenue boundary, so they are well-suited for large-scale investment.

Overall, the regime put many measures in place to ensure that the PIE structure would only be used by genuine CIVs.

III Goals of the PIE Regime

Upon announcing the PIE regime, the Minister of Finance and Minister of Revenue stated:[69]

> We are removing distortions which favour sophisticated direct investors over those who choose to invest through managed funds and unit trusts …
>
> This is no money grab by the government. In fact it will cost about $110 million a year in foregone tax revenue. But if we are to improve the savings culture in this country the government considers this to be a valuable investment to make …
>
> As always there will be winners and losers. The losers in this case will tend to be sophisticated direct investors who have enjoyed considerable tax advantages under the old regime and who have the ability to easily adjust their investment arrangements.
> The winners will be thousands of ordinary, hard working New Zealanders who the government is helping to achieve long term financial security.

Some of these goals are readily identifiable and are worthy goals to strive for. The Government wanted to neutralise distortions, both between domestic and overseas investment and between CIV investment and direct investment. It was concerned with low savings levels and wanted to improve household savings. The PIE regime was interlinked with the KiwiSaver scheme, which the Government viewed as a flagship policy and wanted to ensure its success.

Other goals were stated less explicitly and were influenced by the economic and political context at the time. In encouraging domestic investment, the Government was

65 Income Tax Act, s CB 4. See also *Commissioner of Inland Revenue v National Distributors Ltd* [1989] 3 NZLR 661 (CA).

66 A PIE is unable to use the CFC rules and must instead use the FIF rules: Income Tax Act, s CQ 2(1)(bb). It must use the fair dividend rate method when calculating its FIF income: s EX 52A. Other investors have alternative methods available to them which might result in a lower tax liability than under the fair dividend rate method, particularly when their FIF investments perform poorly: s EX 44.

67 Michael Cullen, Minister of Finance "Address to Finance Professionals" (Wellington, 10 June 2005).

68 Income Tax Act, ss CB 6A–CB 23B.

69 Michael Cullen "$110 million of tax cuts to improve fairness of investment tax regime" (press release, 12 April 2006).

also looking to promote diversification away from property investment. This was combined with an interest in expanding New Zealand's stock market, which was struggling. The Government viewed the CIV, operating under the PIE regime, as the ideal tool for achieving these goals.

Underpinning these goals was a clear vision for horizontal equity. The other goals quickly become inconsequential without consistent tax treatment for investors across different investments and vehicles. Passive investments are mobile, and tax is a significant factor in investment decisions. If PIEs provided a strict advantage to other vehicles, KiwiSaver may appear successful since existing savings would flow into the scheme, but there would be little increase in overall savings levels. If stocks remained heavily taxed compared to property, it is unlikely that a change in CIV rules would result in a noticeable shift in fund allocations.

This Part will assess the various goals of the PIE regime and attempt to measure its success in its current form.

A *Reducing horizontal inequity*

Two principles which are fundamental to the operation of a tax system are horizontal and vertical equity.[70] Horizontal equity is where people in similar positions are treated similarly by the tax system. People who earn the same amount of income should pay the same amount of tax. Vertical equity is where people in different positions are treated differently by the tax system, often based on ability to pay.

The New Zealand tax system attempts to achieve horizontal equity by taxing income arising from different sources at the same rate. For example, when the Government increased the top personal rate to 39 per cent, it took measures to ensure that as many sources of income as possible were captured by this rate.[71] The New Zealand tax system considers that vertical equity can be achieved through a progressive income tax rate regime, which means that tax rates rise as income rises.[72]

One of the principal reasons for the introduction of the PIE regime was to remove inconsistencies in how different investors were treated by allowing CIV income to flow through to investors and be taxed at their personal rate.[73] Lower-income investors pooling money together to invest was seen as an admirable goal, while ensuring that the new system fairly taxed the wealthy and avoided incentivising undesirable tax planning.[74] The PIE regime was an attempt at achieving horizontal equity in investing.

Any misalignment of tax rates creates the opportunity for high-income investors to use vehicles to minimise their tax burden.[75] Prior to the introduction of the PIE regime, companies and trusts were favoured by investors, as both were subject to 33 per cent tax rates compared to the top personal rate of 39 per cent. These entities remain popular investment vehicles.

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70 Inland Revenue *Taxation Principles Reporting Act: Annual Report (Draft)* (December 2023) at 4.

71 Grant Robertson and David Parker *Dividend integrity and personal services income attribution - a Government discussion document* (Inland Revenue, March 2022).

72 Grand Cleland *Income tax rates: Library research brief* (Parliamentary Service, December 2020) at 1.

73 Cullen, above n 43.

74 Cunliffe, above n 13. This article does not suggest that the tax planning described therein constitutes, or should constitute, tax avoidance.

75 Bill English and Peter Dunne "Government to carefully consider tax report" (press release, 21 January 2010).

(1) Trusts

Trustees can elect not to distribute investment income received to beneficiaries and instead retain it in the trust. If the trustees retain the income for six months following the end of the year, the income would be subject to a flat, final tax rate.[76] High-income beneficiaries could then receive their investment income as a distribution without paying their personal rate. The trustee rate increased from 33 to 39 per cent effective 1 April 2024, making trusts a poor option for undesirable tax planning of passive investments from this date.[77]

(2) Companies

Company tax has a dual nature: to ensure foreign investors pay tax on their New Zealand investments while at the same time creating minimal disruption to the taxation of resident investors.[78] The company tax rate essentially serves as a final tax rate for non-resident investors.[79] New Zealand has an interest in keeping this rate as low as possible to ensure that it remains an attractive destination for foreign investment.[80] At the same time, the company tax rate acts only as an interim tax for resident investors due to the operation of the imputation system. A company will pay the corporate tax rate on any profit earned and then be able to attach this tax paid as a tax credit to dividends paid to shareholders. High-income shareholders will then pay additional tax so that their personal rate is applied to dividend income. The lower the disparity between company tax rates and the top personal rate, the less incentive high-income investors have to avoid paying this top-up tax through undesirable tax planning.[81] Of the two competing pressures, it is more critical that New Zealand remains favourable for foreign investors. As a result, the company tax rate was cut to 30 per cent in 2008 and to 28 per cent in 2010.[82] This steady decrease is in line with other OECD countries.[83] There is little prospect of the company rate being raised to match the personal rate in the near term so undesirable tax planning will remain a problem.[84] To the extent that high-income investors can avoid paying the top-up tax, horizontal inequity will continue.

(3) PIEs

The introduction of PIEs as investment vehicles added a new element to the horizontal inequity equation. No issues would arise if PIE investors were taxed in complete alignment

76 Income Tax Act, s HC 7.
77 See Nicola Willis and Simon Watts "Passage of major tax bill welcomed" (press release, 27 March 2024).
78 Inland Revenue *Tax, foreign investment and productivity: Long-term insights briefing* (August 2022) at [6.3].
79 The company may be required to withhold non-resident withholding tax, depending on the circumstances of the non-resident investor. See Inland Revenue *NRWT - payer's guide* (IR291, April 2023) at 15.
80 Inland Revenue, above n 78, at [6.30]–[6.33].
81 At [6.4].
82 Michael Cullen "Company tax rate falls from 1 April" (press release, 1 April 2008); and Bill English "Fact sheet - Company tax cut" (press release, 21 May 2010).
83 Inland Revenue, above n 78, at [6.30].
84 See Inland Revenue *Taxation (Annual Rates for 2023–24, Multinational Tax, and Remedial Matters) Bill – Departmental Report* (February 2024) at 80–81.

with their other income. However, to the extent that PIEs provide investors with a tax advantage over other investing methods, it should come as no surprise that PIEs would be targets for undesirable tax planning.

At all points of the regime's existence, there has been a difference between the highest personal rate and the highest PIR. The current PIRs are 10.5, 17.5 and 28 per cent, based on the investor's income over the prior two years.[85] While the two lower PIRs align exactly with personal rates in rate and bracket,[86] the maximum PIR is lower than the top three personal rates.[87] This differential creates a distortion, making it tax-efficient for an investor on a higher personal rate to invest in a PIE rather than directly. This is detailed in the table below:

Dates	**Highest personal rate (percentage)**[88]	**Highest PIR (percentage)**[89]	**Differential (percentage)**
1 October 2007 to 31 March 2009	39	30	9
1 April 2009 to 31 March 2010	38	30	8
1 April 2010 to 30 September 2010	38	30	8
1 October 2010 to 31 March 2021	33	28	5
1 April 2021 to present	39	28	11

With the differential sitting at 11 per cent, the highest it has ever been, it can be expected that PIEs will be utilised more extensively by high-income investors to minimise their tax obligations.[90] Two important factors exacerbate this: (1) trusts are no longer attractive vehicles for undesirable tax planning, and (2) the PIE discount is guaranteed and immediate. Any savings through companies take time and are subject to a range of rules designed to ensure investors pay their personal rate on dividend income. The PIE has become the premium vehicle for undesirable tax planning of passive investments.

(4) Integrity measures

Initial designs of the PIE regime envisaged PIRs matching personal rates.[91] It is unclear why the Government quickly abandoned this vision. It claimed the cap was put in place to encourage existing savers to continue to save and to encourage CIVs to become PIEs—

85 Income Tax Act, sch 6.

86 Note the two lower PIRs will temporarily misalign with an individual's personal tax rates following the commencement of new tax thresholds on 31 July 2024. The PIR thresholds will be updated on 1 April 2025. See Taxation (Budget Measures) Act 2024.

87 See sch 1 of the Income Tax Act for current personal rates. Lower-income investors do receive a small concession as attributed PIE income is generally disregarded when calculating PIRs. See: Tax Working Group Secretariat *Taxation of Retirement Savings: Discussion Paper for Session 13 of the Tax Working Group* (July 2018) at [39]).

88 Income Tax Act, sch 1.

89 Schedule 6.

90 See for example Katie Dow and Savannah Feyter "New Focus on PIE structures following trustee tax rate increase" (4 July 2024) Bell Gully <www.bellgully.com>.

91 Cullen, above n 46, at [4.23].

statements that broadly fail to justify the existence of a cap.[92] The two further reductions in the top PIR were justified with vague statements of encouraging saving.[93]

Whatever fears the Government may have had of high-income investors abandoning collective investment or CIVs turning up their noses at becoming PIEs seem unfounded. The small tax savings these investors would have lost due to the change in rates would have been dwarfed by the substantial savings gained from removing the capital/revenue boundary in relation to domestic share investments.[94] Government forecasting reflects this view: it budgeted four times as much for the loss of the trading revenue than for the disparity in rates it created.[95] Similarly, any hesitation of CIVs to become PIEs due to increased administrative costs would quickly dissipate as CIVs no longer had to grapple with their biggest problem: uncertainty regarding the capital/revenue boundary.[96]

After the Government raised the top personal rate to 39 per cent with effect from 1 April 2021, the IRD separately investigated steps to address "integrity measures", being potential changes to the existing tax system to ensure the top personal rate was effective and that taxpayers could not use undesirable tax planning to avoid paying this rate.[97] The resulting Government discussion document separated this work into three tranches on the basis of urgency.[98] While the disparity between the personal rate and the rates of companies and trusts were proposed to make up the first two tranches, PIE income was listed as the third possible tranche.[99] The Government stated:[100]

> … given that PIEs are used by large numbers of low- and middle-income New Zealanders, and their taxation is a component of savings policy as well as tax policy, this is not as urgent a concern as the tranche one and tranche two issues.

It appears that no reports on the tranche three analysis are available.

Similarly, when the Government considered raising the trustee rate to 39 per cent, the IRD's corresponding report stated that there was some difficulty in raising revenue from the higher personal rate due to the trustee rate remaining at 33 per cent.[101] It ultimately recommended raising the trustee rate and forecast that the six per cent increase would raise $350 million per year in revenue for the Government.[102] The report noted that even if the trustee rate were to be raised, there would still be loopholes to circumvent the 39 per cent tax rate, both the personal rate and the increased trustee rate, by substituting trusts with companies or PIEs.[103] The report noted that this would not be as effective at reducing vertical and horizontal inequities as a broader change which addressed misalignment of company and PIE rates at the same time.[104]

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92 Michael Cullen and Peter Dunne *Taxation of investment income* (11 April 2006) at 2.

93 Michael Cullen, Minister of Finance "Address to the Deloitte Tax Seminar" (Auckland, 3 July 2008); and Bill English "Fact sheet - Savings tax changes" (press release, 21 May 2010).

94 Stobo, above n 14, at 5.

95 Michael Cullen, Minister of Finance "Address to BT Funds" (Auckland, 26 May 2005).

96 Stobo, above n 14, at 24.

97 Robertson and Parker, above n 71, at 5.

98 At [1.16]–[1.20].

99 At [1.20].

100 At [1.20].

101 Inland Revenue *Regulatory Impact Statement: The Taxation of Trustee Income* (3 April 2023) at [41].

102 At 1.

103 At [51].

104 At [96]–[97].

Submissions on the proposed trustee tax increase noted that the increased trustee rate would result in significant restructuring of investments towards PIEs to reduce tax liability.[105] The IRD responded that the changes would still be worthwhile as these other entities are not perfect substitutes.[106] In relation to PIEs, the report noted that existing trusts have significant active investments which could not be held in a PIE, meaning that at least some trusts would have no alternative but to pay the increased rate.[107] In order to increase horizontal equity, submitters stated that a holistic approach should be taken to remove imbalances between different investment vehicles.[108] In response, the IRD stated:[109]

> We acknowledge that addressing integrity pressures arising from non-aligned tax rates across the tax system at the same time would be preferable to addressing the under-taxation of trust income alone. A cohesive approach to non-alignment would provide further, long-term benefits for the robustness and sustainability of the tax system. This would require making compatible tax changes to both trusts, PIEs and companies/shareholders.

While the Government was correct to raise the trustee rate as an integrity measure, it was wrong to put such low priority on the increase of the top PIR. Passive investment is mobile, making it an easy target for undesirable tax planning. It is much easier to transfer passive investments between entities than restructure an active business to the most tax-efficient structure. It is therefore logical to ensure that PIEs—which exclusively hold passive investments—are the first target of any integrity measures.

The Government's reasoning that ensuring PIR integrity was less urgent due to the use of PIEs by low and middle-income earners, and that PIEs are used for saving, is flawed. While lower-income investors do use PIEs, it is inconceivable that any integrity measures would affect their taxation, as the measures would very likely involve an increase to only the top PIR to align with the highest personal rates. The trust integrity measures clearly target savings and investment—the IRD report itself said that trusts that owned active businesses could not take advantage of the disparity in rates.[110] It may simply be that increasing tax rates on savings in PIEs is politically unpalatable. Commentators have suggested that even a small move toward increasing taxes on PIEs would be controversial.[111]

Unfortunately, it seems that there is little appetite for change in the near term. In its report, the IRD stated that "[t]he Government is not currently proposing to change the tax treatment of PIEs".[112] The lack of a public tranche three analysis appears to confirm that this statement remains true.

105 Inland Revenue, above n 84, at 75.
106 At 76–77.
107 At 76–77.
108 At 77–78.
109 At 78.
110 At 76–77.
111 Baucher Consulting "Budget 2024 preview" (27 May 2024) <www.baucher.tax>.
112 Inland Revenue, above n 84, at 80.

(5) Costs of horizontal inequity

It is difficult to calculate the cost to the government of horizontal inequity arising from the PIR cap. In 2018, the Tax Working Group Secretariat estimated that moving the top PIR from 28 to 33 per cent (then the highest personal rate) would raise approximately $43 million annually.[113] Recent data on tax paid by KiwiSaver providers cannot be generalised as the tax revenue is highly volatile but has been as high as $660 million in 2021, suggesting the cost may be in the hundreds of millions.[114] Still, these estimates do not capture significant portions of investment income due to the PIR cap. One notable example is imputation credits on dividend income.[115] A PIE investor with the top PIR is likely to have no attributed income from domestic share investments, as dividends will have tax paid at source at 28 per cent before the PIE receives the income, resulting in no further tax payable. If the top PIR moves to 39 per cent, the remaining 11 per cent tax—currently not captured—would become payable.

Trusts take advantage of the lopsided tax concessions. Data from the IRD shows that tens of thousands of trusts receive PIE income each year, totalling hundreds of millions.[116] Yet these trusts pay very little tax on their income, with an average tax rate of only 15 per cent across the last four years.[117] While the low rate can be partially explained by the ability of a trust to elect a PIR lower than 28 per cent, likely to distribute the PIE income to lower-income beneficiaries, it can also be inferred that trusts are using PIEs to avoid paying the higher trustee rate.[118] This strategy will likely be used increasingly often as the trustee rate has been raised to match the top personal rate.

While diversified managed funds are the main users of the PIE regime, some unproductive investments use the system and allow their investors to take advantage of the PIR cap. It took less than a year for the concept of a "cash PIE" to develop, in which investors could save money in typical banking products such as savings accounts and term deposits, but through the concessionary PIE regime.[119] These products are now widespread, with most banks offering these products and two of the largest cash PIE funds having combined assets of over $1 billion.[120] A cursory estimate would suggest that, in aggregate, these two funds would pay $14 million per year in tax under the 28 per cent cap compared to $19.5 million per year under a 39 per cent rate, creating a Government shortfall of $5.5 million per year from these funds alone.[121]

113 Tax Working Group Secretariat, above n 87, at [94].
114 Letter from Sandra Watson (Inland Revenue) to redacted recipient regarding PIE tax levied on KiwiSaver accounts (22 August 2023) (obtained under Official Information Act 1982 request to Inland Revenue) at 1.
115 The IRD has given different responses to Official Information Act requests as to the PIE tax for the 2018 and 2019 years. See letter from Mike Nutsford (Inland Revenue) to M P Ross regarding tax monies relating to KiwiSaver (5 May 2020) (obtained under Official Information Act 1982 request to Inland Revenue); and Watson, above n 114. The difference appears to be attributable to these forms of upstream income being attributed back to the PIE.
116 Letter from Sandra Watson (Inland Revenue) to redacted recipient regarding PIE income and tax attributed to trustees (11 December 2023) (obtained under Official Information Act 1982 request to Inland Revenue) at 1.
117 At 1.
118 Income Tax Act, s HM 57(f).
119 Cullen, above n 93.
120 InvestNow "Thoughts on short-term money storage options: Why managed cash PIE funds are a no-brainer for Anthony Edmonds" (22 November 2023) <www.investnow.co.nz>.
121 This calculation assumes a consistent asset base of $1 billion, an interest rate of 5 per cent and that all investors are subject to the top personal rate.

The PIR cap is costing the government unknown but vast amounts of foregone revenue as high-income investors ensure that their passive investments are held in PIEs rather than in a manner that could require the investor to pay their personal rate on their investment income.

B *Improving savings rates*

The Government considered that the low household savings rate was hampering New Zealand's long-term growth prospects.[122] It therefore sought to increase savings rates to promote economic growth.[123] In addition, a higher level of savings was crucial to the future of retirement in New Zealand. While New Zealand Superannuation provided a base income level in retirement, it was not intended to be the retiree's sole income.[124] Studies aroused concern that future retirees would rely more on private savings to maintain a reasonable standard of living.[125]

Overseas studies have found a strong relationship between income and savings rates.[126] Savings rates increase as income increases, with the lowest earners saving very little, if any, and the highest earners saving more than a quarter of their income. Marginal propensity to save also appears to increase as income increases. If a low-income earner and a high-income earner each earned one extra dollar, the low-income earner would be expected to save around 3 cents while the high-income earner would save over 40 cents.[127] The picture in New Zealand appears consistent within the academic literature, with savings rates steadily increasing as a household earns more income.[128]

International comparators show that any tax incentives for savings must be carefully designed, or they will likely be primarily funnelled through to high-income earners.[129] Tax incentives alone do not appear to succeed in encouraging savings.[130] The ideal target group is thought to be middle-income households, as they can generally afford to save but often fail.[131]

The Government was aware that not all savings are equal:[132]

> We want to encourage genuine savings not simply divert what might have been saved anyway down alternative avenues. Designing a package that achieves the aim of increasing private savings whilst remaining equitable is difficult but we believe it is a goal worth striving for.

122 Michael Cullen, Minister of Finance "Speech to Auckland Chamber of Commerce" (Auckland, 23 February 2005).
123 Michael Cullen, Minister of Finance "Address to Banker and Investment Forum" (Tauranga, 19 April 2005).
124 (2 March 2006) 626 NZPD 1673.
125 Savings Product Working Group, above n 23, at 21.
126 Karen E Dynan, Jonathan Skinner and Stephen P Zeldes "Do the Rich Save More?" (2004) 112 J Political Econ 397 at 399–400.
127 At 429.
128 Tax Working Group Secretariat, above n 6, Appendix A at [4].
129 Savings Product Working Group, above n 23, at 14.
130 At 12.
131 Tax Working Group Secretariat, above n 87, Appendix D at [7].
132 Cunliffe, above n 13.

This view is consistent with studies on the success of tax incentives. These studies will often distinguish between existing savings being reallocated and new savings.[133] Tax incentives mostly cause high-income savers to move their existing savings towards the new vehicle, which receives the benefit of the incentive.[134] Meanwhile, new savings—often from lower-income investors which would otherwise have likely been spent—are far more difficult to encourage. It is attracting these new savings which makes any savings scheme successful. The Australian superannuation scheme can be pointed to as an example of such success. By making savings compulsory, the scheme attracted significant new savings and appeared to have formed long-term savings habits beyond the compulsory amounts.[135]

In New Zealand, the government attempted to capture new savings by making PIEs attractive to lower-income investors. It removed tax disadvantages for lower-income investors who previously used CIVs, as they would now be taxed based on their PIR rather than the corporate rate of the CIV. At the same time, the government ensured that gains on the sale of New Zealand, and most Australian, shares would be excluded from the income of the PIE.[136] Regardless of whether the PIE is passively holding or actively trading the shares, this ends the problems arising from the capital/revenue boundary. This solved the key issue: that individuals would be presumed to hold shares on capital account and have their gains untaxed, while CIVs would be presumed to hold shares on revenue account and, therefore, be liable for tax on all gains.[137]

What benefit do these changes provide for lower-income investors? Arguably little. While lower-income investors who already had funds in CIVs are no longer over-taxed on their investments, these are existing savings rather than new ones. With or without these changes, a lower-income investor could invest on their own account and pay their personal rate on investment income. There is no clear reason why low-income earners who do not currently save will begin saving due to the introduction of the PIE regime.

Middle-income earners at 30 and 33 per cent personal rates do receive some benefit from the PIR cap of 28 per cent. This disparity is likely to create some new savings as these investors receive direct savings from PIE investments compared to other options. However, a discount of a couple of percentage points may not be sufficient to generate substantial new savings or create a savings culture.

The primary beneficiaries of the PIR cap are high-income earners on 39 per cent personal rates. While most jurisdictions that use tax incentives couple them with a limit on the maximum possible savings—such as by setting a maximum annual contribution—the PIE regime has no such limit, meaning high-income earners can avoid paying their personal rate on a theoretically unlimited amount of investment income.[138] As these investors already have a high propensity to save, significant incentives are likely to produce few new savings. Instead, substantial undesirable tax planning may occur, reallocating existing savings held elsewhere towards the PIE regime.

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133 *Saving New Zealand: Reducing Vulnerabilities and Barriers to Growth and Prosperity - Savings Working Group Final Report to the Minister of Finance* (January 2011) at 78.

134 At 78.

135 David Skilling *It's not just about the money: The benefits of asset ownership* (The New Zealand Institute, Discussion Paper 2004/2, 22 October 2004) at 28.

136 Income Tax Act, s CX 55.

137 Inland Revenue *Tax Information Bulletin* (Vol 19 No 3, April 2007) at 45.

138 Tax Working Group Secretariat, above n 87, at [56].

The limited available data appears to confirm this. The PIE regime has greatly benefitted CIVs, with rapid growth in funds under management.[139] However, at the same time, household debt remains high, and savings rates remain low.[140] It seems likely that the PIE regime has experienced a substantial influx of existing savings but has yet to create new savings.

The failure to create new savings exacerbates savings disadvantages faced by specific demographics:[141]

> People who experience gender, ethnic, or disability pay gaps, occupational segregation, lower levels of participation in the labour market (through part-time work and time out of paid work) or who carry an unequal burden of unpaid work, are disadvantaged from saving. Māori, Pacific Peoples, and women are over-represented here.

While tax concessions alone are unlikely to be able to close any gap in savings between disadvantaged groups and the rest of the population, the Government should at least ensure that these disadvantaged groups receive equitable tax treatment if they are able to save. Removing disadvantages faced by lower-income investors was a directive for the *Stobo Report*, yet it has not carried through to the PIE regime.[142]

It seems that the PIE changes have failed to spark an improvement in New Zealand's savings culture. While household debt levels have flattened out from the concerning rise seen in the early 2000s, they remain high and show little sign of reducing.[143] Consequently, savings rates remain low, with households in total spending more than they are saving.[144]

C *KiwiSaver*

The PIE regime was the first step in promoting savings. KiwiSaver was the second.[145] The two frameworks were designed with the other in mind and are complementary. Where the PIE regime would make saving more attractive by removing distortions between different types of investments and different ways of investing, KiwiSaver would make saving easy by allowing all employees automatic access to a CIV and incentives for all individuals to join voluntarily.

The Government was hesitant to use tax incentives to promote savings:[146]

> It is clear that tax incentives for saving can be inefficient, and can incur high costs for quite low levels of net increase in savings. Tax incentives can also be quite inequitable. Those who have such low incomes that they cannot save do not have the potential to access the incentives, so the objective of bringing a larger proportion of the population into the ambit of retirement savings is not fulfilled.

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139 Reserve Bank of New Zealand "Managed funds: Funds under management (T40)" <www.rbnz.govt.nz>.

140 Reserve Bank of New Zealand "Household Debt (as a % of Household Nominal Disposable Income)" <www.rbnz.govt.nz>; and Tax Working Group Secretariat, above n 9, at [75].

141 Te Ara Ahunga Ora Retirement Commission *Arotakenga o ngā Kaupapapahere Whiwhinga Moni Ahungarua: Review of Retirement Income Policies* (29 November 2022) at 71.

142 At 36.

143 Reserve Bank of New Zealand, above n 140.

144 Tax Working Group Secretariat, above n 9, at [75].

145 At [17].

146 Cunliffe, above n 13.

The Government was right to take this view, as international examples suggest that any tax incentives must be carefully designed in order to be effective at increasing uptake.[147]

On the other hand, in the early design phases of KiwiSaver, the Savings Product Working Group was worried that savers would be hesitant to join a scheme without incentives.[148] Among other options, it considered the use of direct incentives to encourage membership, including a fixed "dollar booster" to supplement the first contributions to the scheme and "top-ups" to reward regular contributions.[149] It warned against using top-ups as they were likely to be too expensive to be meaningful, qualification would necessarily be arbitrary, and they would discriminate against existing superannuation schemes.[150] These risks seem to apply equally to dollar boosters.

Regardless, the Government used top-ups and dollar boosters as direct incentives to promote KiwiSaver, in addition to the benefits that contributors received from the concessionary PIE regime. The Government provided an initial kick-start payment of $1,000 for members joining KiwiSaver.[151] It then matched member contributions at a one-to-one ratio up to a cap of approximately $1,000 per year.[152] These incentives were subsequently wound back, halving the contribution matching ratio and removing the kick-start payment.[153] These incentives to date total over $14 billion, with the bill at $1 billion per year for the government.[154]

These incentives were a significant investment by the Government to guarantee the scheme's success. On the face of it, they were successful. Most of New Zealand's population has joined KiwiSaver, with over 3 million members.[155] Funds under management were over $80 billion by 2021,[156] exceeding the Government projection of $60 billion.[157] They now exceed $110 billion.[158] Over half of contributions come directly from members.[159]

A closer look tells a more worrying story for the ongoing prosperity of New Zealand savers. About half of all members do not regularly contribute to their KiwiSaver, with another third only contributing the default rate, likely in order to receive employer and government matching.[160] Only a fifth of members make contributions beyond what is necessary to receive matching. The average balance sits at around $33,000,[161] only enough to replace New Zealand Superannuation payments for little more than a year.[162]

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147 Savings Product Working Group, above n 23, at 12.
148 At 36.
149 At 66–68.
150 At 67–68.
151 Michael Cullen "Budget gives $40 a week to support saving" (press release, 18 May 2007).
152 Cullen, above n 151. This incentive was labelled as a "tax credit", despite being a direct payment from the government to members.
153 Te Ara Ahunga Ora Retirement Commission *KiwiSaver: Opportunities for Improvement* (June 2024) at 14.
154 Inland Revenue "Statistics on payments to scheme providers" <www.ird.govt.nz>.
155 Financial Markets Authority *KiwiSaver Annual Report 2024* (24 September 2024) at 5.
156 At 14.
157 Bill English and Peter Dunne "KiwiSaver contributions to increase from 1 April" (press release, 28 March 2013).
158 At 14.
159 Inland Revenue, above n 154.
160 Inland Revenue, above n 154.
161 Financial Markets Authority, above n 155, at 2.
162 Ministry of Social Development "How much you can get for NZ Super" Work and Income <www.workandincome.govt.nz>.

Another concerning story is the rise in the use of KiwiSaver to purchase property. One of the few purposes for which KiwiSaver funds can be withdrawn before retirement is for members to purchase their first home. Of the $11 billion contributed in the 2024 financial year, around 10 per cent was flowing out for house deposits.[163] While this helps achieve the worthy goal of enabling first home buyers to own their own home, it undermines the government's intentions in designing savings reform. The government wanted New Zealanders to move away from property and towards productive assets, such as shares. Instead, by withdrawing their funds, first home buyers are effectively selling shares to buy property. This comes at significant direct cost to employers, the government and publicly listed companies, as well as indirect societal costs to the extent that funds are being misallocated into unproductive assets. At the same time, recent research confirms that KiwiSaver and other private savings are being increasingly relied upon by retirees—bringing into question how savers can afford retirement if they are drawing on retirement savings to purchase their first home.[164]

While these incentives can rightly be criticised for their cost and failure to create a savings culture, they have made important steps towards creating a national savings scheme out of thin air. Unlike the PIR cap and many international examples, the incentives target the correct group: lower-income earners. The incentives have been deliberately designed to be most attractive to this group. Everyone was entitled to the kick-start payment, and most workers receive the full government contribution, even if they contribute the minimum amount.[165] Although many members make limited contributions, these are almost certainly new savings. KiwiSaver has, therefore, made some dent in the low savings rates of lower-income earners, even if it has not yet created a broader savings culture.

D *Neutrality*

On the face of it, the Government was a strong proponent of neutrality amongst investments:[166]

> Economically sound savings will occur only if the tax rules governing different kinds of investments are as neutral as possible. As you will probably know, however, the current tax rules for savings are far from neutral.

Underneath the façade of neutrality, the Government attempted to nudge investors in two directions: away from foreign investment and towards domestic investment; and away from property ownership and towards share ownership.

Before the PIE regime, investors were taxed differently on their share investments depending on whether their investment took advantage of the grey list. This disparity was problematic because it gave direct investors an advantage over those investing in CIVs, and lower-income investors were unlikely to take advantage of the grey list due to a lack of wealth, confidence and financial literacy.[167] More broadly, the Government wanted to

163 Financial Markets Authority, above n 155, at 12–13.

164 Te Ara Ahunga Ora Retirement Commission, above n 141, at 13.

165 A worker earning more than $34,762 and contributing at least three per cent will be eligible for the full government contribution. A full-time minimum wage worker making the minimum contribution will meet this threshold.

166 Cullen, above n 28.

167 Cullen, above n 69.

remove the attractiveness of foreign investment in general and promote domestic investment.[168]

The Government was also concerned about the high rates of property investment.[169] It was concerned that investors were "under investing" in all other asset classes.[170] Share ownership was viewed as a sound hedge against the potential of falling house prices,[171] and an increasingly necessary source of income for retirement.[172]

The Government addressed the first disparity by bringing all offshore portfolio investments under the FIF regime. The most common mechanism for direct investment, and the enforced mechanism for PIE investment, is the fair dividend rate (FDR) approach, which deems five per cent of the market value of the offshore portfolio to be taxable income.[173]

The Government addressed the second disparity by allowing CIVs to hold and trade domestic shares without paying tax on capital gains. Share ownership would be promoted as participation in CIVs—which often invest in shares—became relatively more attractive.

While the two changes are conceptually distinct, their effects should be considered in tandem as they influence the same behaviour: the tendency of investors to invest in shares.

The creators of the regime drew mixed conclusions on how foreign investment should be treated. The *Stobo Report* considered that investors are better off where they can compare post-tax foreign returns directly to pre-tax domestic returns.[174] The Government shared this sentiment, stating that "the economy works best when investment decisions are guided as much as possible by economic considerations and as little as possible by tax considerations".[175] Despite these views, tax avoidance and capital flight concerns crept into the process. Stobo was concerned about the inability of the IRD to collect tax on foreign profits.[176] The Government wanted to remove any incentives favouring foreign investment over domestic investment.[177] As a result, both concluded that domestic and foreign shares could not be taxed on the same basis.

The FIF rules impose an artificial wealth tax on foreign shares, while domestic shares are only taxed on the dividends they pay out to investors. The FDR method deems five per cent of the value of the foreign portfolio to be income.[178] This is higher than what an investor would pay on a balanced domestic portfolio, where dividend yields are approximately three per cent.[179] Assuming the top PIR applies, a foreign portfolio loses nearly 1.5 per cent of its value to tax every year, regardless of the performance of the

168 Cullen, above n 69.
169 Cullen, above n 122.
170 Cunliffe, above n 13.
171 Michael Cullen, Minister of Finance "Address to Property Council" (Auckland, 11 August 2005).
172 Cullen, above n 151.
173 Peter Dunne, Minister of Revenue "Superannuation and tax" (speech to Superannuation funds AGM, Auckland, 11 October 2006). See also above n 66.
174 Stobo, above n 14, at 4.
175 Michael Cullen "Stobo report on taxing investment income" (media statement, 16 November 2004).
176 Stobo, above n 14, at 26.
177 Cullen, above n 69.
178 See above n 66.
179 NZX New Zealand's Exchange "NZG" (26 January 2024) <www.nzx.com> [NZG]; and NZX New Zealand's Exchange "AUS" (26 January 2024) <www.nzx.com> [AUS]. See also Tax Working Group Secretariat, above n 6, at [23].

underlying shares.[180] As investors receive a lower net return on foreign shares than domestic shares with the same pre-tax performance, they are discouraged from building a global portfolio.

This distortion would be inconsequential if an investor could build an adequate share portfolio using only domestic shares. However, this is not the case. It is widely accepted that international diversification is desirable for share portfolios as it reduces the overall risk without harming returns.[181] The Australian and New Zealand stock exchanges represent only a fraction of the size and value of global share markets.[182] A balanced global portfolio would be subject to FIF tax on approximately 98 per cent of its holdings.[183] KiwiSaver providers recognise the need to diversify beyond domestic shares, with approximately two thirds of their share investments being international.[184]

Compared to share investment, property investment is relatively unaffected by the FIF rules. The benefits of international diversification in property investment are far less clear, and it is accepted that it is difficult for direct investors to acquire and manage property in other countries.[185] This makes the FIF rules rarely relevant for property investors. In addition, property benefits disproportionately from New Zealand's lack of a capital gains tax.[186] These factors make property investment far more tax-efficient than share investment, despite this being the opposite of the intended effect of the changes.

Investors have responded to this distortion by avoiding shares and instead choosing property. Only seven per cent of New Zealanders' investments are in domestic shares and less than one per cent in foreign shares, compared to 13 per cent in investor housing.[187] Since the early 2000s, levels of share investment have remained consistently low among households while property investment has remained consistently high.[188]

The Government was warned that the changes would push investors away from shares and towards property.[189] The Government dismissed these claims, stating that: (1) CIVs were the largest investors in foreign shares and any disadvantage from the FIF rules would be outweighed by the concessionary treatment they would receive under the PIE regime; and (2) investors would only be affected if they owned more than $50,000 in foreign shares due to a de minimis threshold which was introduced alongside the changes.[190]

These arguments fail to properly address the warning. There is no risk of PIEs pivoting from shares to property. The problem takes root one level down: an investor who is otherwise indifferent will avoid the PIE that holds foreign shares, leaning instead towards

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180 Direct investors are slightly better off, as they can use the comparative value method to reduce their tax liability in weak years. See Susan Edmunds "The capital gains tax you don't know you're paying" (8 September 2023) Stuff <www.stuff.co.nz>.

181 Najah Attig and others "What explains the benefits of international portfolio diversification?" (2023) 83 J Int Financ Mark Inst Money at 2–3.

182 Andrew Morrison *The New Zealand Stock Exchange: demutualisation, merger and other issues* (Parliamentary Library, 2001/5, 6 April 2001) at 10.

183 Vanguard *Annual Report: Vanguard Total World Stock Index Fund* (31 October 2023) at 5 and 52.

184 Financial Markets Authority, above n 155, at 28.

185 Patrick J Wilson and Ralf Zurbruegg "International Diversification of Real Estate Assets: Is It Worth It? Evidence from the Literature" (2003) 11 JREL 259 at 259–260.

186 Tax Working Group Secretariat, above n 9, at [20].

187 Tax Working Group Secretariat, above n 87, at [31].

188 Stats NZ "National accounts (income, saving, assets, and liabilities): March 2024 quarter" (4 July 2024) <www.stats.govt.nz> at supplementary table 1.5B.

189 Michael Cullen, Minister of Finance "Address to property law conference" (Wellington, 12 June 2006).

190 Cullen, above n 189.

other PIEs or, more likely, direct property investment. Any investor in a PIE which holds foreign shares pays FIF tax indirectly, regardless of the amount they have invested, rendering the de minimis threshold irrelevant in these circumstances.

The FIF changes lacked nuance and failed to consider the behavioural effects on investors. Their failure to stimulate share investment can be demonstrated through the ongoing struggles of the NZX. Before the changes, the NZX was performing poorly, to the point where it was considering merging with its Australian equivalent.[191] Twenty years later, the number of listed companies on the NZX remains low.[192] By creating a distortion away from shares, the PIE regime influences investors' decisions and reduces their incentive to diversify.[193] This harms the development of New Zealand's capital markets, which in turn hurts the country's economic growth prospects.[194]

E *The managed funds industry*

The Government sought to grow the managed funds industry by steering investors away from direct investment and towards collective investment. One of the claimed benefits of this move was that direct investors were more likely to invest in established companies, while CIVs could invest in new, small or risky firms.[195] The Government also saw a path to property ownership for lower-income investors through the securitisation of property.[196]

There is little doubt that the managed funds industry has benefitted greatly from the PIE regime. Funds under management are five times what they were at the release of the *Stobo Report*.[197] Many benefits should flow from the blossoming of the managed funds industry: funds can make investments which would otherwise be unavailable for lower-income investors; funds can make investments in riskier or newer businesses; investors can benefit from the expertise of the manager; and by pooling funds, investors face lower costs and risks than by investing directly.[198] A stable managed funds industry is integral to a strong and independent financial system.[199]

The sustainability of the managed funds industry could be an argument in favour of retaining a PIR cap. High-income earners provide a significant source of funds for PIEs, and a tax concession encourages them to keep funds in PIEs, even if the funds are simply a reallocation of existing savings. However, it is to be doubted whether this is necessary given the maturity of the KiwiSaver scheme and the lack of alternative vehicles for undesirable tax planning. PIEs retain their key advantage over other vehicles: they can ignore the capital/revenue boundary.

Simultaneously, the managed funds industry in New Zealand does not appear to be achieving the full potential of collective investment. PIEs tend to over-invest in public companies and under-invest in private ones.[200] This is despite private investments having a time horizon well-suited to collective investment and the private investment market

191 Morrison, above n 182.
192 TheGlobalEconomy.com "New Zealand: Listed companies" <www.theglobaleconomy.com>.
193 Tax Working Group Secretariat, above n 6, at Appendix A.
194 Tax Working Group Secretariat, above n 87, at [12]–[14].
195 Cullen, above n 46, at [2.16].
196 Cullen, above n 189.
197 Reserve Bank of New Zealand "Managed funds: Funds under management (T40)" (26 November 2024) <www.rbnz.govt.nz>.
198 Tax Working Group Secretariat, above n 6, at [7].
199 Cunliffe, above n 13.
200 Ernst & Young *Growing New Zealand's Capital Markets 2029: A vision and growth agenda to promote stronger capital markets for all New Zealanders* (9 September 2019) at 25.

growing substantially in recent times.[201] Similarly, KiwiSaver funds nearly exclusively invest in large, listed companies alongside debt investments, with funds avoiding land and unlisted companies.[202] The FMA suggests that, at most, two per cent of KiwiSaver funds are invested in private assets.[203] This is compared to approximately 18 per cent of Australian superannuation schemes[204] and 27 per cent of the NZ Superannuation Fund,[205] and is out of step with superannuation schemes globally and leading institutional investors.[206]

This funnelling of investments has severe implications for businesses, investors and society. Businesses struggle to receive funding and, therefore, struggle to grow.[207] Investors lose the benefits of diversification and early-stage investment in growth companies. Society suffers as investments such as venture capital, infrastructure, social housing and sustainable investment receive limited funding.[208]

The Government is currently investigating reform into regulatory settings of KiwiSaver funds in order to enable them to better invest in private assets.[209] Any reform of this nature should be welcomed and broader reform of any PIE rules which inhibit private investment should follow. One particular area of focus should be rules which encourage daily pricing, as this can be difficult to apply to illiquid assets.[210]

F *No abuse*

Any tax system should have measures which minimise opportunities for tax avoidance or undesirable planning. This was especially important for the PIE regime due to its novelty, and the propensity in the investment sector to use undesirable tax planning.[211] As a result, the PIE regime has several eligibility requirements to ensure it is being used appropriately by genuine CIVs.

The regime envisages that PIEs are primarily engaged in passive portfolio investment. This is demonstrated by restrictions on how much of a company the PIE can own,[212] and an inability to use associated person leasing for large land businesses.[213] The income type requirements limit active income streams, such as management fees.

Before the regime's introduction, the Government identified two potential avenues for abuse: through active property businesses and PIE subsidiaries.[214] It made changes to

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201 At 19.
202 Tax Working Group Secretariat, above n 6, at [27]–[30].
203 Financial Markets Authority, above n 155, at 28.
204 Centre for Sustainable Finance: Toitū Tahua, Chapman Tripp and MinterEllisonRuddWatts "Legal opinion finds regulatory settings discouraging some investment options for KiwiSavers" (press release, 29 February 2024).
205 Guardians of New Zealand *Superannuation Annual Report 2023* (24 October 2023) at 40.
206 Centre for Sustainable Finance: Toitū Tahua, Chapman Tripp and MinterEllisonRuddWatts, above n 204.
207 Tax Working Group Secretariat, above n 6, at [219].
208 At [220].
209 Andrew Bayly "Invigorating New Zealand's capital markets" (press release, 13 December 2024).
210 Letter from Lloyd Kavanagh and others (MinterEllisonRuddWatts and Chapman Tripp) to Joanna Kelly (Chief Executive of Centre for Sustainable Finance) regarding KiwiSaver investing in private assets (11 December 2023) at [4.1].
211 Cullen, above n 28.
212 Income Tax Act, s HM 13.
213 Section HM 12(1)(b)(iv).
214 Michael Cullen "Government to close PIE tax loopholes" (press release, 6 September 2007).

prevent these kinds of abuse before the regime came into effect, and the PIE regime has remained relatively unchanged since its introduction.

Investors have a strong incentive to abuse the PIR system, for example, by notifying the PIE that they have a lower PIR than is correct. To deal with this, the regime introduced a mechanism to allow for tax adjustments where an investor has had tax deducted at an incorrect PIR.[215] Before introducing the tax adjustment provision, it appears there was widespread abuse of the disparity between PIRs.[216]

The IRD is aware of other ways investors can avoid tax through PIEs. One identified method is borrowing funds to invest in a PIE and then claiming the interest on the loan as a deduction.[217] This method takes advantage of the difference between the top PIR and the top personal rate. The IRD notes that this type of arrangement is unrealistic in practice.[218]

Overall, beyond the issue of incorrect notification of PIRs, which has since been corrected, it appears that very few cases of abuse have surfaced. PIEs are required to provide information to the IRD frequently, and the attribution method provides transparency when calculating tax liability. These design features minimise the risk of future abuse, and the regime appears successful in this regard.

IV Suggested Changes

The *Stobo Report* taught that trade-offs will be involved when designing a tax regime. Compromises between goals must be achieved, and it is necessary to consider which goals should take priority when suggesting changes.

The most important goal of the PIE regime was to enable horizontal equity between investors. Investors should face similar tax treatment regardless of the vehicle they use and their selected assets. A glance at the PIE regime shows that this goal has yet to be achieved. High-income earners can avoid paying their personal rate by using PIEs to hold investments. Shares remain unattractive compared to property. Therefore, the focus of suggested changes should be on restoring horizontal equity.

Comprehensive reviews of New Zealand's tax system have noted an anomaly when drawing international comparisons: the lack of a concessionary tax regime for retirement savings.[219] Most other OECD countries offer tax-advantaged savings accounts that allow contributions to be made by investors from pre-tax income and only impose tax when savings are withdrawn. Funds are also generally not taxed while they are invested. Although a change towards this model would have clear benefits in encouraging saving,[220] it appears unlikely in the near term due to its large upfront cost.[221]

More broadly, there seems to be limited appetite and ability for tax concessions for savings and investment. Since the introduction of the PIE regime, concessions and

215 Income Tax Act, s HM 36B.

216 See Tom Pullar-Strecker "Huge numbers who underpaid tax on KiwiSaver last year 'off the hook' for previous years" (5 June 2019) Stuff <www.stuff.co.nz>.

217 Inland Revenue *Income tax: scenarios on tax avoidance—2023* No 1 (QB 23/01, 3 February 2023) at [51]–[82].

218 At note 12.

219 Tax Working Group Secretariat, above n 9, at [75].

220 See Ernst & Young, above n 200, at 74–75.

221 Tax Working Group Secretariat, above n 87, at 35.

incentives have gradually been reduced rather than increased.[222] Therefore, for changes to be realistic, they should aim to be either revenue-neutral or revenue-positive for the Government.

A *Aligning PIRs with personal rates*

Misalignment of the top personal rate, the top PIR and the company and trust rates leads to undesirable tax planning.[223] High-income investors will be able to move their investments towards lightly taxed entities. This reduces the revenue that higher rates can collect, and have a lowest common denominator effect, where any rates above the lowest entity rate are unlikely to be particularly effective.[224] The PIE is currently a favourable entity in this regard due to the PIR cap. The top personal rate is the biggest loser from any misalignment, as high-income investors minimise their personal tax liability where there are incentives to use vehicles.[225]

Therefore, this article first suggests aligning PIRs completely with personal rates. This would remove the 28 per cent cap and raise the top PIR to 39 per cent. Minor tax concessions which promote simplicity—such as excluding PIE income when calculating an investor's PIR and allowing PIRs to be calculated from either of the prior two years—should be retained.

This approach would almost entirely solve the horizontal equity problems under the PIE regime by ensuring investors paid taxes according to their personal rates. It would remove the current regressive tax concessions, which are costing the government an unknown but vast amount of foregone revenue with little evidence that they are encouraging saving. The government could use this extra revenue to offer alternative savings incentives or other projects which assist in saving. It would substantially remove any opportunities for investors to minimise their tax bill by investing in PIEs, and unproductive investments such as cash PIEs would cease to be attractive. Presumably, these changes would be relatively simple to carry out, as PIR bands have already been changed numerous times since the inception of the PIE regime with little issue.

A complete alignment does carry some risks. Complete alignment substantially removes any incentive for high-income investors to utilise PIEs, and these investors may divert their investment income through alternative vehicles to avoid high personal rates. Similarly, CIVs may restructure their funds so they are no longer PIEs, to make their funds more attractive to investors.

A flight of CIVs from the PIE structure would appear unlikely, as PIEs carry the substantial advantage of tax-free gains on domestic equity. However, restructuring by high-income investors would remain a real risk.

As explored in Part III, trusts and companies are the main vehicles used for undesirable tax planning. The recent increase to the trustee rate will leave trusts as a poor option for passive investment. As the company rate appears unlikely to move, it becomes the logical destination. For domestic investors, the company rate is only a withholding rate, with imputation credits providing a mechanism to align the progressive personal rate scale with the flat company rate. High-income investors can delay their final tax payments so long as

222 At Appendix C.
223 Robertson and Parker, above n 71, at [1.13].
224 At [1.13].
225 Inland Revenue, above n 78, at [6.22].

their investment income remains within the company.[226] It may even be possible to turn this delay into a permanent tax saving, such as by selling the shares in the company as a capital gain before any income is distributed.[227]

The Victoria University of Wellington Tax Working Group considered that it was crucial to the coherence of New Zealand's tax system that the top personal rate, trustee rate and top PIR are aligned, even if the company rate remained lower.[228] While acknowledging the risk of companies being used to avoid paying tax at these top rates, it suggested that measures could be taken to mitigate this risk.[229] For example, passive income derived by a company could face a surcharge to the usual company rate if it was not distributed within a certain timeframe. This seems to mirror closely trust rules, which deem undistributed income to be trustee income.[230] These measures fall outside the scope of changes to the PIE regime and would need to be considered separately on their own merits.

The capital/revenue boundary would also operate as it did in relation to CIVs before introducing the PIE regime, potentially deeming companies which hold investments to be in the business of investment and imposing tax on capital gains earned by the company, rather than just passive income. It is unclear whether the IRD can monitor and enforce this tax obligation.

A full alignment approach would raise revenue for the government and increase horizontal equity. It would create the risk that the company would take the PIE's position as the premium undesirable tax planning vehicle, but options exist that could mitigate this risk.

B *Broadening the PIR discount*

A more muted approach to full alignment would be redistributing the existing tax concession to benefit all investors equally. An example would be adjusting each PIR to be five per cent lower than its counterpart personal rate.

This approach would result in low-income earners paying less tax, middle-income earners paying similar amounts of tax, and high-income earners paying more tax on their investment income than they currently do. All investors would receive the same tax concession. This would create a more targeted incentive to increase savings rates, as lower-income investors would receive a modest decrease in their tax liability. Combined with the existing KiwiSaver incentives, such a tax incentive could finally help spark a savings culture in New Zealand.

Naturally, this change would not result in the same horizontal equity as a full alignment change would create. However, arguably, horizontal equity would increase compared to the status quo. As the broad discount would place the top PIR at 34 per cent, similar undesirable tax planning concerns through companies would arise as if the top PIR was increased to 39 per cent. However, the advantages of using companies would be more limited due to the smaller disparity between the company rate and the top PIR. While a high-income investor could theoretically make a tax saving by using a company and deferring distributions, they would remain liable for the full top-up tax if the company distributes its income. On the other hand, the investor would be entitled to an instant

226 Stobo, above n 14, at 5.

227 *Tax System for New Zealand's Future: Report of the Victoria University of Wellington Tax Working Group* (January 2010) at 29.

228 At 10.

229 At 43.

230 Income Tax Act, ss HC 5–HC 7.

discount through a PIE, with freedom of withdrawal. A high-income investor would not have strong incentives to use a company, although it would remain a risk.

Lower-income investors could similarly take advantage of tax planning by reallocating existing savings into PIEs to reduce their tax liability. For these investors, a reallocation into PIEs may encourage future saving, as research shows that once people start saving, they are likely to continue.[231] This would create an opportunity for desirable tax planning.

A broad PIR discount has been viewed positively by government working groups in the past. The Savings Working Group suggested a five or 10 per cent discount across all PIRs.[232] The Tax Working Group recommended a five per cent discount of the lower rates for KiwiSaver funds only, while retaining the 28 per cent rate cap.[233] At the time, this would have led to a five per cent discount across the board.

It is unclear what effect imposing a broad discount would have on tax revenue. The Tax Working Group estimated that a five per cent discount on lower rates for KiwiSaver funds, while retaining the 28 per cent rate cap, would cost $630 million over five years.[234] It seems unlikely that the cost would be so high for the current proposal, where the 28 per cent rate cap would be abandoned. However, the net effect would be unclear due to a lack of information on PIE tax revenue and the inability to predict how these changes would influence investor behaviour.

A broad discount on investment income may have positive effects on society. Lower tax rates on savings reduce incentives for individuals to consume instead of save, helping increase the savings that investors have at the end of their time horizon.[235] A discount to the lower PIRs would benefit all investors, not just lower-income investors. As investors age and move into part-time work or retirement, they would benefit from low tax rates being levied on their investments as they become an important source of income. The same applies to investors who temporarily reduce or stop work due to factors such as tertiary study, temporary unemployment or raising children.

Overall, a broad discount would offer greater savings incentives for lower-income investors. However, it would lack the horizontal equity of a full alignment approach, and the fiscal position would be uncertain.

C *Reducing the FIF rate*

The current FDR of five per cent applied to FIFs is set at a level which over-taxes foreign investment relative to domestic investment.[236] An option to address this could be to reduce the FDR when it is applied to FIFs held by PIEs. A potential rate could be three per cent, approximating current dividend yields for a portfolio of domestic shares.[237] This was the benchmark rate used by the Tax Working Group.[238] Alternatively, the rate could be tied

231 Skilling, above n 135, at 27.
232 Peter Dunne, Minister of Revenue "Address to the Tax Agents' Institute of NZ Annual Conference" (5 March 2011).
233 Tax Working Group *Future of Tax: Final Report Volume I - Recommendations* (21 February 2019) at 80.
234 At 93.
235 Savings Working Group, above n 133, at 79.
236 Tax Working Group Secretariat, above n 9, at [23].
237 NZG, above n 179; and AUS, above n 179.
238 Tax Working Group Secretariat, above n 9, at [23].

to a benchmark that is updated yearly and designed to represent expected income from domestic portfolios.[239]

This approach would make investing in certain PIE funds, namely those which have a global share portfolio, more attractive. In particular, it would further encourage a shift away from direct investment (which would remain subject to the full FDR) and towards collective investment, helping achieve a key goal of the PIE regime. Although direct investors would retain the de minimis threshold, the discount would benefit less financially literate investors who are likely to invest small balances in a managed fund without being aware of the tax implications arising from the current FIF framework.[240] It would also substantially achieve the goal of neutrality, encouraging share investment at the expense of less productive investments, particularly property. It is considered economically efficient for investors to compare post-tax foreign investments to pre-tax New Zealand investments, which this change would enable.[241]

Any worries from the government about significant capital flight towards foreign investment would likely be overblown. Despite the emergence of global financial markets and the increase in the accessibility of foreign markets to New Zealand investors, research shows a strong correlation between domestic savings and domestic investment, suggesting that most savings remain in their country of origin.[242] Evidence in New Zealand shows that foreign shares remain a small fraction of a household's share investments, with domestic shares being heavily preferred.[243]

The remainder of the FIF rules would remain intact, so any change should be simple and minimally disruptive. The likelihood of abuse seems minimal, with the main case being other investment vehicles forming a PIE to hold their foreign investments. However, they would need to meet the various requirements which are in place to ensure that the PIE was only used for genuine collective investment. Using an estimated total of foreign share investments of $61.5 billion, PIEs currently pay around $861 million in FIF tax, which would reduce to around $517 million under a three per cent FDR, at a fiscal cost to the government of $344 million annually.[244] While this change alone could initially be revenue-negative for the government, it could create revenue-raising opportunities if it prompted investors to shift their investments from property, which is lowly taxed, towards shares.

V Conclusion

The main goal of the PIE regime was to create horizontal equity. Before its introduction, arbitrary tax treatment of investments resulted in low savings, a poor economic state and unfair tax burdens.

While the government removed some distortions hampering investment, it created new ones. The worst offender is the PIR cap. The government attempted to make collective

239 This type of variable rate is currently used by the IRD for the deemed rate of return method for calculating FIF income.

240 Stobo, above n 14, at 26–28.

241 Cullen, above n 46, at [5.15].

242 See generally Martin Wallmeier and Christoph Iseli *Home bias and expected returns: A structural approach* (2022) 124 J Int Money Finance; and Kernel Wealth "Home & Away – Investing in Global vs NZ Shares" (27 October 2023) <http://kernelwealth.co.nz>.

243 Stats NZ, above n 188.

244 Reserve Bank of New Zealand "KiwiSaver: Assets by sector (T43)" <www.rbnz.govt.nz>; and Reserve Bank of New Zealand "Retail unit trusts: Assets by sector (T45)" <www.rbnz.govt.nz>.

investment more attractive for lower-income investors while limiting the benefits that would accrue to high-income investors. Yet this vision never materialised, meaning that high-income investors continue to receive significant tax concessions for investing in a PIE. In contrast, lower-income investors receive little or no benefit. Beyond the inequity, these concessions come at a large and unknown fiscal cost. Evidence broadly suggests that these concessions are ineffective, and the lack of concessions for lower-income investors may harm overall savings rates. Two potential solutions to this problem are to remove the concession and align PIRs with personal rates, or to spread the concession so that all investors receive similar benefits. These solutions would increase horizontal equity and provide the government with additional revenue for more effective savings incentives.

The Government wanted to increase savings rates amongst New Zealand households. In addition to using the PIE regime to achieve this goal, it sought to establish and promote KiwiSaver as a means of saving privately for retirement. It provided a range of concessions to PIEs and direct incentives for investors to join and save via KiwiSaver. These methods had mixed success. KiwiSaver is incredibly popular and continues to grow, although it appears yet to create a savings culture in New Zealand, with few members contributing beyond the minimum. Significant portions of KiwiSaver funds are either direct contributions from the government or employers or used for purchasing property rather than retirement. Any combination of a PIR discount for low-income earners and a discount on the FIF tax paid by KiwiSaver funds would be a step towards future success. However, broader reform may also be necessary.

The Government wanted to remove existing tax distortions on investments while nudging investors in directions it considered desirable. It successfully identified and eliminated the main distortions of the prior tax rules. However, while tinkering, the government created a new distortion that punished share investment, harming CIVs. Share investment remains low, and property remains attractive. The economy continues to be hamstrung due to the lack of a thriving financial market in New Zealand. Reducing the FDR for PIEs would substantially remove this distortion and put different kinds of investments on a relatively level playing field. This would enable investors to choose productive investments without tax being a factor in their decision-making.

One of the initial drivers behind the eventual work on tax reform was the struggling status of the managed funds industry due to inhibitory tax rules. The managed funds industry has grown substantially since the inception of the PIE regime. This growth should carry benefits for the wider economy. Yet, these benefits do not appear to have transpired as KiwiSaver funds invest nearly exclusively in assets already available to individual investors. The Government is rightly investigating reform in this area.

Finally, the Government wanted to ensure the PIE regime was coherent, workable and abuse-free. In this respect, they must be commended. The PIE regime has clear requirements that draw reasonable boundaries between a genuine passive CIV and other investment entities. While there have been a few fringe abuse cases, rules have quickly been amended to prevent widespread abuse, and the system appears to remain largely intact. This shows that the PIE regime is amenable to change when there is appetite for it. This article has set out to explain why there should be further appetite for improvement.

For now, however, it seems there is no change on the horizon for PIEs, with the latest annual tax bill not including any major changes to the PIE regime.[245]

245 See Taxation (Annual Rates for 2024–25, Emergency Response, and Remedial Measures) Bill 2024 (73-1); and Baucher Consulting "New tax bill drops" (5 September 2024) <http://baucher.tax>.