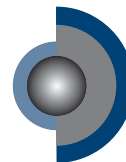
A SELECT VIEW

INVESTMENT TAX SUPPLEMENT

NEW INVESTMENT TAXATION RULES



On Tuesday 12th December, Parliament passed the new Taxation (Annual Rates, Savings Investment, and Miscellaneous Provisions) Bill. This Bill introduced the final version of the taxation of international investments as well as changing the way collective investment vehicles (managed funds) would be taxed in NZ. It also finalized some taxation issues around employee superannuation contributions.

The effects of the Bill are far reaching for NZ tax resident investors. We provide a summary of the new rules and discuss some of the implications for investors.

A) Taxation of Offshore Investments

Applies to foreign investment fund interests ('FIFs') including companies, shares, managed funds and super funds. The start date is 1st April 2007 and 1st October 2007 for managed funds that intend to become Portfolio Investment Entities ('PIEs').

New overseas tax rules

Currently investors in overseas companies and funds that are located in grey list countries (UK, US, Australia, Japan, Germany, Canada, Norway) received a grey list exemption from the current FIF rules and were normally only taxed on income received from those investments and not capital gains.

Investors in companies based in countries outside this list were subject to FIF rules and normally taxed on both income and capital gains. So, most NZ investors have been investing their overseas portfolios into funds or companies tax resident in grey list countries.

The new rules change the way FIF interests are taxed and removes the old grey list country regime for investors with less than a 10% direct interest in an FIF. This is referred to as a portfolio interest. Those investors with more than a 10% interest will remain subject to the current FIF rules.

The new rules therefore apply to most investors with portfolio interests. Under the new rules the portfolio investment will either be:

A) Exempt and taxed on income received only (not capital gains unless a trader).
B) Non–exempt and subject to the new rules.

1) Exempt Investments

- Australian Listed Companies ('ASX') that are also tax resident in Australia and on an approved ASX index.
- Certain Australian Unit Trusts that have a Resident Withholding Tax proxy for NZ investors. They also have to meet a turnover minimum where unrealized gains are no more than 3x any realized gains in any income year.
- Some venture capital funds that move offshore to raise capital
- Employee Share purchase schemes while access to the shares are restricted
- Guinness Peat Group – specific 5 year exemption
- New Zealand Investment Trust – specific 2 year exemption
- Australian Superannuation Schemes (regulated schemes)
- Investors (natural persons) with less than $50,000 invested in an offshore portfolio

2) Non-Exempt Investments - New Rules – the 5% Fair Dividend Rate ('FDR')

- Applies to all other overseas portfolio interests*
- Default method applies where taxable income will be assessed as being 5% of the total portfolio value at the start of each year.**

SELECT ASSET MANAGEMENT

- For individuals and family trusts that have portfolio returns in a year that are actually less than 5% then that actual return will be assessed as income at that level, or if the portfolio return is less than 0% then no tax is payable but no tax losses are created either.
- NZ companies, superannuation funds and managed funds will have their returns in these investments assessed as income at 5% regardless if the actual return is less than this.
- 'Quick Sale Method'. If a share or unit is bought and sold in the same year than the lesser of 5% of the average cost of the shares or the actual gain on those shares (including any income) is assessed as income.
- Foreign tax credits would normally be available as an offset***

*Where this is a less than 10% direct portfolio interest.

**Other Methods. Where it is not practical to establish a market value for the investments then investors can choose an alternative 5% of cost method. Other methods such as Comparative Value, Deemed Rate of Return and Accounting Profits calculations may also be used instead of FDR.

*** There is a difference between the use of FTCs for individuals and family trusts vs NZ domiciled managed funds (under the new PIE regime).

FDR cannot be used if:

1) A direct interest is more than 10% of that interest (either any time in the year for a non-grey list country or anytime during the year if a non-grey list country).
2) The interest in the company or fund is a fixed rate share, non-participating redeemable share or the company or fund has 80% of its asset value in financial arrangements denominated in NZ dollars.
3) The Commissioner determines that the interest is not a type for which the FDR is appropriate
4) An interest that provides a guaranteed return (higher price than the issue price). Must have no or immaterial contingency for the issuer.

B) New Portfolio Investment Entities ('PIES')

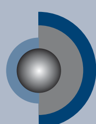
Start Date. 1st October 2007

Currently NZ resident managed funds are taxed on both income and capital gains. They are also taxed at 33% with some of that tax non-recoverable for 19.5% tax rate investors.

Better rules for local funds

New rules for NZ managed funds will be introduced under the PIE regime. These include NZ resident Unit Trusts, Listed Investment Companies, Superannuation Funds and Group Investment Funds (but not life insurance funds). They can elect to be a PIE if they meet eligibility requirements. The regime tries to ensure that the tax liability is assessed at the investor level and not the fund level. To become a PIE a NZ domiciled managed fund has to meet certain requirements and make an election to Inland Revenue.

- The PIE collects the tax for investors (investors give their tax rates to PIEs). Income distributed from PIEs to investors becomes "excluded income" and is not assessed.
- The PIE is taxed at the investor tax rate to a maximum of 33% (so 39% taxpayers get an advantage).
- PIEs can buy and sell shares (trade) without being subject to tax on the capital gains (or losses) of those shares…an advantage over direct investors.
- PIEs can have a loss in an income period.
- PIEs can allocate rebates they receive (losses, excess imputation credits and other NZ tax credits) to investors. This may only be a notional allocation.
- Foreign tax credits can only be used to offset tax in that year. Excess foreign tax credits are lost and are not rebatable to investors.



PIES can also have different tax payment treatments. Unit Trusts and Group Investment Funds have different tax payment timing options (quarterly, provisional tax and annual exiting investor methods). Stock Exchange listed PIES and superannuation schemes will pay tax at 33% under provisional tax rules.

- Listed PIEs can only have one class of investor. They are treated as qualifying companies, taxed at 33% and treated as a provisional tax payer. Dividends would be excluded income to investors and imputation credits not usable to investors unless they are 19.5% taxpayers (who elect to include the income and access the imputation credits). Therefore 19.5% taxpayers in listed PIEs will need to provide a tax return.
- Super PIEs pay provisional tax based on the weighted average tax rates of members but have a base 33% tax rate. Tax losses and credits do not pass to members but can be used to offset tax in the fund. They provide an interest adjustment to 19.5% taxpayers at the end of each year if required.

Custodial or wrap providers investing in PIEs can be the tax collector in which case they will be 0% rated investors. They will receive gross income and will need to withhold tax for investors (they perform the PIE tax compliance obligations).

PIEs are taxed on shares cum dividend. I.e. if a share is sold after a dividend has been declared and not yet paid the dividend is still taxable to the PIE.

PIE investments into companies where 90% or more of the company assets are land will be treated as if the PIE holds land assets.

Life Insurance Companies cannot themselves be PIEs but can hold up to 100% in a PIE.

C) SSCWT Salary Sacrifice (Specified Superannuation Contribution Withholding Tax)

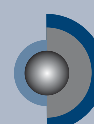
Tax break for larger PAYE employees

The new Bill also confirmed the threshold rules around superannuation salary sacrifice. Under measures introduced this year to stop ‘extreme’ salary sacrificing – where a 39% taxpayer has the majority of his salary received as an employer super contribution such that their tax rate drops to 19.5% or even 15%.

The new rules are: SSCWT thresholds have been set based on the aggregate of an employers contribution, and employees salary.

Up to $11,400	15%
Between $11,400 and $45,600	21%
Over $45,600	33%

While this puts paid to extreme sacrifice tax strategies it still means that contributing to super can still provide a tax benefit for large earners (33% rather than 39%) subject to the fact these contributions may be subject in some circumstances to Fund Withdrawal Tax (5%) for early fund withdrawal.



D) KIWISAVER

Kiwisaver legislation was enacted 6th September 2006. The scheme launch date is the 1st July 2007.

The objective of the scheme is to encourage work based savings. The scheme is available to all workers. New employees aged between ages 18-65 are automatically enrolled and have to opt out if the don't want to contribute to the scheme. Existing employees can opt in.

First step towards compulsory superannuation

Key Features

- Contribution levels are either 4% or 8% of wages (including bonuses, commissions, etc). Contributions from employers are subject to the SSWCT rates (see prior section). The employer can contribute up to 4% and their contribution up to the level of the employees contribution is exempt and not taxed.
- Member funds must be locked into age 65 (or minimum of 5 years membership – whichever is longer). Access for hardship, emigration, serious illness.
- Members can take contribution holidays after 12 months for up to 5 years.
- After 12 months members can divert 50% of employee contributions into mortgage repayment.
- First home purchase. Members can make a 1 time withdrawal after 3 years membership equivalent of $1,000 per year up to a maximum of $5,000 to apply to a home deposit.
- Government will contribute $1,000 to each member at start up (can't be withdrawn).
- Government will subsidise the fees of the default scheme providers
- Self-employed people can elect lower than 4% but needs to be the minimum 4% to get access to the housing deposit subsidy.
- Members can't borrow against their accounts

Who can provide a scheme

- Kiwisaver schemes will be run by the private sector with contributions flowing via the IRD (from payrolls).
- There are 6 default providers of schemes. If an employee or employer does not select a different scheme then the IRD will place the funds into a default provider (ASB, AMP, ING, AXA, Tower, Mercer).
- Non default schemes do not get the manager fee subsidy from the Government.
- All providers will need to interface with the IRD.

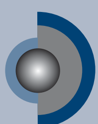
Scheme Requirements

- Register as a Kiwisaver super scheme with at least 20 non-associated members.
- Have Government actuary approval and provide required reports
- Be transferable
- Meet the lock in rules
- Meet the minimum contribution rate requirements
- Provide interfaces with IRD

Existing Schemes

- Can convert to a Kiwisaver Scheme and move current members into it if terms are better under the converted scheme (to Government Actuary satisfaction).

Non-Kiwisaver schemes must be registered by 1st July 2007 to get SSCWT exemption on employer contributions and even then only existing employer participation agreements will be eligible.



Asset Planning and Management Issues Arising from these Changes

1) Asset Allocation Impact of International Tax Changes

The new tax impact is less than originally proposed

The new Fair Dividend Rate (FDR) has a material impact on the net return investors were getting from their overseas share portfolios (if they were investing in grey list companies and funds). Our back testing of these new rules shows that over the last 10 years this tax would have subtracted an additional -0.9% p.a.

We show the impact below for a 33% taxpayer for different long term return expectations.

Total Return	Pre Change After Tax Return p.a.	Revised After Tax Return p.a.
Cash	3.5%	3.5%
NZ Bonds	4.1%	4.1%
Global Bonds	4.1%	4.1%*
NZ Shares	10.1%	10.1%
Global Shares	11%	**10.1%**
Direct Property	7%	7%
Hedge Funds	8.3%	**6.7%**

* It may be possible to access listed companies/funds offshore that hold fixed interest assets. If these are subject to FDR then return from Global Bonds can be enhanced on average to 4.6% after tax from 4.1%.

The ability for direct investors and family trusts to pay tax on the lower amount of return in years where returns are less than 5% means the effective assessed level of income for tax is lower than 5% each year. We would expect this to be somewhere between 3.0% to 4.5% p.a. in the future.

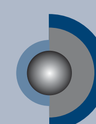
This changes the efficient frontier for investors and also their asset allocation. For example let's look at a sample portfolio asset allocation pre and post the new rules and look the impact on returns and risk.

International shares should be retained

Assets	Pre	Post	New Rules Same Return	Old Rules Same Risk	New Rules Same Risk
	%	%	%	%	%
Cash	4	4	4	4	4
Australasian Shares	18	18	25	22	22
NZ Bond	18	18	15	14	18
Alternative Assets	14	14	14	15	14
Direct Property	5	5	5	5	5
Global Bond	18	18	14	14	17
Global Shares	23	23	23	26	20
	100	100	100	100	100
Expected Return	7.4%	7.0%	7.4%	7.0%	7.1%
Std Deviation	7.8%	7.7%	8.7%	7.8%	7.8%
Income	40%	40%	33%	32%	39%
Growth	60%	60%	67%	68%	61%

What does this example show? Firstly, that the portfolio returns from the same asset allocation will drop and the risk will also slightly drop (tax smoothes returns). This means investors either have to accept a lower return or change their asset allocation to have a greater exposure to higher risk assets (most likely Australasian shares) to get the same return outcome. It also shows that Global Shares continue to play a critical part and that any allocation to them is only likely to be marginally reduced.

Investors (particularly independent trustees) should seek professional asset consulting advice with respect to the impact of these changes.



2) New Funds Available for International Investment

Better choice

The Grey list removal for portfolio interests of less than 10% opens up access to other country domiciled funds. This possibly creates more choice for investors (Luxemburg SICAVs, Irish UCITs and others). The universe of tax acceptable fund choices will now increase. Advisers and investors will now need to assess these opportunities as part of any fund selection process.

3) Direct Overseas Investment or via a PIE?

FDR still favors direct overseas interests rather than via a NZ PIE. PIEs are taxed at 5% deemed rate of return while direct interests are taxed at 5% FDR. PIEs do not get the benefit of paying less tax if the actual return is lower than 5%...direct investors do.

4) Which is Better? - Exempt Overseas Investment or FDR?

Care required when selecting overseas assets

Exempt overseas interests (Australian shares and some Australian Unit Trusts) are ok where their expected income is 5% or less. Otherwise, FDR is actually better. So high yielding Australian shares for instance would be better under FDR. Low yielding Australian shares benefit from their exemption. Some Australian Unit Trusts will be exempt if they use a NZ RWT proxy and meet portfolio turnover requirements. These trusts would only be attractive if they had low income, high capital growth investments. The turnover provisions reduce their attractiveness but there may a place for them.

Australian Unit Trust investments may actually be more attractive under FDR. This is because AUTs need to distribute any realized capital gains when they turn their portfolio over. These gains plus any currency gains are often distributed to investors at quite high levels. This always provided a level of risk for NZ investors into these funds who could receive large random distributions (turning capital into income). Under FDR only 5% will be assessed. This effectively caps the risk of investing into these funds as distributions will not be assessable income.

5) Investors Costs with the new International Rules

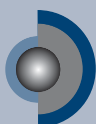
Increased administration

Rather than just paying tax on any distributions and using any foreign tax credits investors will now have to undertake calculations each year to determine their tax liability.
Initially for 1st April 2007 and then at the 1st April each year, investors will need to value their portfolio. In addition to this valuation any buying and selling of the same shares in any year will require an additional ‘quick sale’ calculation.

The easiest way to address this problem is to either use a PIE and let the manager work it out, or to use a custodial service that can also perform the calculations automatically. Otherwise, investors and or their accountants will need to do this work.

Where there are no ready market values for interests in private companies and the like, valuation will prove a far more difficult exercise each year. There are provisions for using historical cost methodologies to help resolve this.

Cash flow issues. Where the return from international shares has a lower income yield than the 5%, the tax liability will be have to be funded. PIEs will have to retain some cash in their funds to do this on behalf of their investors. Direct investors will need to fund the tax liability out of other funds and provide for this tax under provisional tax payment rules (again a custodial service would help towards alleviating this work).



6) Locked in (or term) International Funds

Though we counsel our own investors from using locked in fund structures there are many NZ investors that have money in international funds (particularly Australian Unit Trust structures) that are locked in for a fixed period and have little or no market liquidity. Depending on the nature of these investments they may be exempt, or subject to FDR. Where they are exempt they will be taxed on distributions only. Most likely, they will be subject to FDR and as such investors will need to pay tax each year on 5% of value (unless the actual total return is lower) even if investors get no income from the investment.

The real issue with locked in funds is where investors were expecting to get the majority (or all) of their return as a capital return and pay no tax which will now be taxed at FDR. So for funds that may have offered an "indicated yield of x%" on the assumption investors would not be paying tax on that will now be unlikely to meet their targets. This may reduce any market value for these investments.

7) Direct Australasian Shares or use a PIE?

Trading benefit versus high costs

At present any trading or rapid turnover of holdings in shares can constitute a trading activity subjecting any returns to assessable income. Unlike direct investor's PIES will be able to trade as much as they like and not have any gains (or losses) assessed as income. Some investors may see this active trading as an advantage providing an opportunity to deliver additional excess returns (or Alpha). Any additional benefit from active trading would still need to outweigh the costs of active trading and the management fees associated with it.

Listed NZ PIEs offer access to tax benefits that were trapped at company level as gross income and tax credits flow to investors at their marginal tax rates. Listed Property Trusts benefit from this in particular. This is very attractive to 39% taxpayers but appears to be reflected in the prices of these funds which rapidly rose once the rules were announced late last year.

8) $50,000 exemption limit (di minimis)

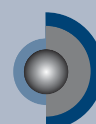
Small benefit for small portolios

Natural persons (not trustees of family trusts) receive an exemption from the FDR rules if their total international portfolio investments that would be subject to FDR are less than $50,000 at 1st April 2007. Therefore, there is a tax benefit for individuals to hold lower than $50,000 in their own name and only be taxed on the income. This could mean some tax saving. A 33% taxpayer (assuming past earning rates on international equities average 1.5% income and 10% growth) could get an average tax saving of about $575 p.a. (33% x 3.5% of $50,000). A 39% tax payer $533 p.a.

However, we know that from past experience there will be years of loss and earning rates of less than 5%. Assuming an actual future tax liability of closer to 3% (for family trusts and individuals) would drop the tax saving to $248 p.a. for a 33% taxpayer and $203 p.a. for a 39% taxpayer. These are relatively minor benefits and would not warrant moving assets out of a family trust back into the names of beneficiaries or settlors to utilize the di minimis, particularly if there are additional costs involved in management or reporting.

9) Tricky Dicky Opportunities

Apart from trying to exploit the obvious (high yielding FDR overseas investments and low yielding exempt investments) there will be a range of funds created over time to try and exploit the capital/ income boundary. There can be some very specific benefits for being treated as an FDR. It is tempting to try and have low risk high yielding investments taxed at the FDR cap of 5%. This could make the risk adjusted returns from such fund very attractive (providing any fund manager fees do not gouge the benefit).



While the new legislation creates quite broad powers of review for the Commissioner to determine if an overseas interest is exempt or subject to FDR there are also interestingly quite specific exemptions from FDR such as:

- The interest in the company or fund is a fixed rate share, non-participating redeemable share or the company or the fund has 80% of its asset value in financial arrangements denominated in NZ dollars.
- An interest that provides a guaranteed return (higher price than the issue price).

Broad review powers for IRD

This would lead one to think that there may be possibilities for a unitized non fixed rate or guaranteed return Australian Unit Trust investing in higher yielding fixed interest assets that is only assessed at 5% FDR.

Example: Let's say a NZ investor would normally buy and hold NZ corporate bond(s) in their own name. They might think there is an arbitrage opportunity to use an Australian Unit Trust with similar assets that are taxed under FDR rules. This might look good at first glance but is it? Say the AUT had 75% of its assets in 100% hedged NZ dollar corporate bonds yielding 8% (meeting the 80% rule) and 25% of it's assets in Australian corporate bonds (hedged) yielding 7%. This could create a fund that yields say 7.75% which after fund fees of say 1% yields 6.65% pre-tax to the investor. This would only be assessed at 5% FDR. The after tax yield for a 33% taxpayer would be 5%. However, if instead I had just invested in the 8% NZ bonds directly then a 33% taxpayer would net 5.4%!

To make this income/capital boundary arbitrage with FDR investments the assets in the fund would need to be in higher yielding and higher risk (self defeating) debt securities.

Investors should be cautious of these types of funds until the risk adjusted return is understood as funds managers may promote them, take their fees but leave investors with higher risk assets for the return they are getting.

10) Salary Sacrifice & Kiwisaver

PAYE savings

There are clearly opportunities to use superannuation and Kiwisaver to generate tax efficient savings. Funds that meet the Kiwsaver requirements will be able to have matching employer contributions up 4% of the total employee wages/salary (including bonuses).

While the superfund needs to meet the conditions required it means that a portion of a salary could be sheltered. This is attractive for high PAYE earners.

Example:

- $350,000 PAYE employee.
- 4% employee contribution or $14,000 taxed at SSCWT rate of 33% instead of 39% is a $840 saving. A 4% employer contribution or $14,000 not taxed instead of 39% is a $5,460 saving. Total benefit a tax saving of $6,300 p.a.
- This of course does not prevent the employee from salary sacrificing a greater portion into super and saving 6% for every dollar saved in tax (Note: there is an additional 5% tax to be paid if superfund withdrawals are made under certain conditions).

The downside of Kiwisaver is the required lock-in provisions limiting access to funds until age 65. Providing investors have alternative sources of capital and can get access to efficiently operated funds this may not be an issue. The Kiwisaver holdings would be consolidated alongside other savings and investments for asset planning and management purposes.

PO Box 2683
Shortland Street
Auckland 1015

Level 7
Old South British Building
3-13 Shortland Street
Auckland

Ph: 09 377 5777
Fax: 09 377 5772
www.selectam.co.nz
email: info@selectam.co.nz

SELECT ASSET MANAGEMENT