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Savings and investment tax

2007 has become a watershed year for changes to the taxation of investments for New Zealand investors.

Following a Government review and the implementation of the KiwiSaver scheme, new taxation rules were introduced. The changes were comprised of the introduction of the Fair Dividend Rate (FDR) regime for offshore equity investments, and the Portfolio Investment Entity (PIE) rules for New Zealand-based managed funds.

The purpose of the changes was to ensure that investments made directly by individuals or through managed funds are treated equally. The previous investment tax rules created distortions between different types of investment.

The new rules, taking effect from the 2008 income year, change the influence of tax as a factor in investment decisions.

Implications

While the tax on investment and savings becomes simpler than in the past, we expect more investors to seek advice. This is because it's now more important to select the most efficient investment option. Likewise it's now very important to accurately determine the right PIE tax rate and to calculate the assessable income (for offshore shares and offshore funds).

Because of the increased compliance costs and complexity associated with FDR calculations, many smaller investors are likely to use PIEs.

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The $50,000 exemption

This exemption (or threshold) applies to individuals with a total cost of offshore equity investments of $50,000 or less throughout the whole income year – thereby removing them from the FDR regime.

Though simple in principle, this exemption has provoked confusion with some international investors believing they should reduce their offshore holdings to below $50,000 prior to the legislation coming into effect.

This view, however, is mistaken and can lead to some real inequities, particularly in a down market – as demonstrated in the table below.

Investment cost	FDR exempt $45,000	FDR compliant $55,000
Net dividend @ 2.5%	$1,125	$1,375
FDR taxable amount	-	-
Total investment return (inc dividends)	-7.50%	-7.50%
Taxable amount	$1,125	-
Tax liability @ 33%	$371.25	-

Clearly, the investor who is able to use the FDR regime is better off – from a tax perspective – than the investor who cannot, as the FDR-compliant investor may elect to apply the CV method resulting in no tax payable for the year.

The outcome for the investor taxed under the FDR regime, as shown above, is that no tax will be payable on the return.

Using FDR means the investor's final tax position is better suited to the ebbs and flows of equity market performance over time.

Managed funds vs direct holdings

Investors with direct offshore holdings will generally find that the new Portfolio Investment Entity (PIE) regime for managed funds offers a more favourable investment platform than direct holdings. This is because the relative tax advantage of directly held shares over managed funds has been removed. Investors with marginal tax rates of 33% or 39% are also advantaged because PIE investor tax rates are capped at 30%.

Another key feature of the PIE regime changes is that gains from the sale of New Zealand and Australian equities are now exempt from tax.

Conclusion

Overall, the outcome of these broad-ranging investment tax changes is very positive for investors. The FDR regime, for example, simplifies tax on offshore shares, while the PIE regime makes managed funds a more favourable investment platform due to the removal of a tax advantage for direct investors and the introduction of a capped 30% tax rate.

The opportunity now exists for many investors to significantly reduce the tax they've been paying on their investments. Specifically, you will be impacted by these changes if you are invested in:

- Term deposits
- Finance companies
- Direct shares
- Managed funds (domestic or international)

Given the sweeping nature of these changes to investment tax, we strongly recommend that you review the tax position of your investments. It is likely that your preferred investment platform and mix could change.

KiwiSaver update

The Labour Government's budget announcement on 17 May included some significant enhancements to KiwiSaver – the work-based savings initiative – as the launch date of 1 July 2007 approaches.

The enhancements, including compulsory employer contributions and associated tax credits for both employers and employees, provide strong incentives for employee participation in the KiwiSaver scheme.

Under the KiwiSaver budget proposals, employers will be required to match employee contributions to KiwiSaver up to 4% of the employee's gross salary. The employer contribution will be phased in over four years commencing 1 April 2008. Contribution levels will start at 1% in 2008 and rise by 1% per year until 1 April 2011, from which time the full 4% will be payable.

From 1 July 2007, all employee contributions to KiwiSaver will be matched by a tax credit of a maximum of $20 per week ($1,040 per year). This is in addition to the Government's $1,000 kick-start contribution paid to each new KiwiSaver account (plus the subsidy of $40 per annum towards the payment of KiwiSaver fees).

The Government will provide employers with a contribution of $20 per week per employee ($1,040 per employee per year) towards the employer contribution. This will be done via a credit through the PAYE system.

Employer contributions will not count towards the minimum 4% employee contribution.

As some of these enhancements are phased in progressively over the next four years, it's likely that New Zealanders will take up KiwiSaver in stages.

Ownership strategies for protecting your assets

Protecting the assets you have accumulated over your lifetime is essential for the long-term financial wellbeing of yourself and your loved ones.

In order to do this effectively, the ownership structure of your assets requires special consideration. Having the most appropriate structure in place will ensure that if an unforeseen or adverse event occurs, the assets are not lost or their value diminished.

In this article, we'll discuss two ownership options well suited to situations where more than one party is concerned.

Joint ownership

Joint ownership most commonly arises in marriages and other personal relationships, particularly where a couple both own the home they live in. If one of the joint owners passes away, their share of co-owned assets automatically passes to the surviving joint owner.

At a glance, this may be exactly what both parties desire. However, the economic realities of such an arrangement may not be in the surviving partner's best interests.

For example, if the surviving partner were to enter long-term care, they would then become subject to asset testing. In such a situation, full ownership of the property could have a negative impact on the value of any subsidy they receive while in care.

The solution to this might be to create a 'tenancy in common'.

Further information can be found at www.kiwisaver.govt.nz

Tenants in Common

This type of ownership arrangement is usual where friends purchase a property together or where a couple wishes to provide for others in their wills. The property can be owned in shares according to the agreement between the owners. Where one of the registered owners dies, their share passes to whomever the deceased owner selected in their will, or to what is known as a 'testamentary trust'.

Under such a trust, the chosen beneficiaries – perhaps, in this case, the remaining partner – would have a life interest in the assets without actually owning them directly. The structure, operation and protections offered by a testamentary trust, once set up, are therefore much the same as a family trust.

Conclusion

A will ensures that your assets are distributed in the manner that (and to whom) you wish. However, it's important to remember that while marriage automatically cancels an existing will, separation and divorce do not. On the other hand, if you die and have not prepared a will you will die 'intestate'.

When this occurs the deceased's estate is distributed according to the law on 'intestacy', which may not be desirable or in line with your last wishes.

Similarly, if a will is not changed following a divorce it remains valid. As a result, your will may distribute assets to a former partner even years after the marriage/relationship is dissolved.

Careful consideration needs to be given when determining whether your current asset ownership structure is the best way to protect your hard-earned assets. These views are a general interpretation of the law and you should seek qualified advice before taking any action on restructuring the ownership of your assets. If you have any questions regarding your trust or the ownership structure of your assets, please contact your professional financial adviser.

Risk? What risk?

The world of investments has changed considerably in recent years, with the flow of liquidity gathering volume and pace consistently since the tech bust of 2000.

Liquidity flow has been constant and robust, charging headlong through short-term 'bumps' such as the Shanghai sneeze in late February-early March and enabling private equity and most global share markets to set records in 2007. Market stability has been further bolstered by the world's developed economies successfully controlling inflation. This, in turn, has led to relatively low interest rates internationally.

What we see now is a global market flush with capital (or liquidity), relaxed about the possibility of risk and seeking higher returns than those available through the usual interest rate-based investment channels.

Despite a strong appreciation in the New Zealand dollar which has impacted on portfolio returns, global equity performance has been stellar over the past 12 months. The MSCI World index, which tracks share markets (in local currency terms) in 23 developed economies, and the Dow Jones Industrial Average (a major US index) both reached new all-time highs at the end of the quarter to 31 May 2007. Investors, and particularly private equity managers, have reaped the benefits of an extended period of 'golden weather' which has led many on both sides of the investment equation to lose sight of the 'elephant in the middle of the room' – that being risk (or volatility).

So where's the smart money going? Several strategies can deliver higher-than-interest rate returns without unnecessarily increasing risk and the threat of capital loss – the first (and foremost) being diversification. Your financial adviser can construct an investment portfolio that is suitably diversified in terms of asset class, geographic location and investment strategy to reduce the overall likelihood that an event in the global equity or credit environments would compromise portfolio returns.

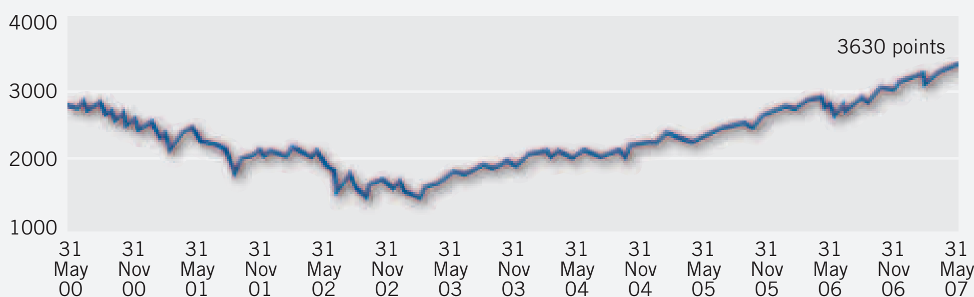
While asset class (ie equities, bonds, cash etc) and geographic diversification are self-explanatory, there are nuances to investment strategy – particularly where specialist managers (such as hedge funds) are concerned – which require some further explanation.

Specialist managers use specific strategies to protect (or hedge) their investments against adverse market movements. A wide and complex variety of strategies is utilised by these managers, with each seeking to profit from different market opportunities using different techniques and different instruments.

Overall these strategies seek to manage volatility and, where possible, generate positive returns regardless of how the broader markets might be performing.

If you are interested in knowing more about allocations within your portfolio to specialist managers, please talk to your financial adviser.

Global equities, as measured by the MSCI World index which tracks the performance of share markets in 23 developed economies, have reached record levels during May



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