Shameless tax incentives
A comfortable truth

With the PIE regime, Michael Cullen has doled out tax incentives for all – and that is not a dirty little secret, according to AMP Capital's Anthony Edmonds

By Anthony Edmonds

Now don't get me wrong, my Mum's a good stick and I love her dearly, but she does have one habit that baffles me. She assumes that just because something is obvious to her, everyone else will know exactly what she means. Meanwhile, I find myself lost as she delivers the punchline to a joke or a story.

Recently I was reminded that I am well and truly a chip off the old block. On last month's IFA roadshows I asked each audience the same question: "Why did Dr Cullen cap the tax on PIE [portfolio investment entity] funds at 30% when we have marginal tax rates of 33% and 39%?"

As I heard the answers, I repeatedly found myself in the same position my Mother often is. Knowing exactly what the punchline is, but with everybody else around me confused. In the main, people said it was either to align the tax rate for investment funds with the new company tax rate, or that it was in fact a mistake that Cullen would fix later.

On only one occasion did I hear the punchline that I had assumed everyone knew to the PIE story: "It is a tax incentive to get people to save."

My first response to this experience was to check my facts to see if I was right.

Perhaps the purpose of PIE wasn't really to create tax incentives. But, no. Right there in question one on the Treasury's website under the section on 'Savings tax rate: questions and answers' for the Budget 2007 it says:

Why is the tax rate on different savings products being reduced to 30%?

The tax reduction is to encourage individuals to save. Less tax paid on income from the savings vehicles will mean faster accumulation of savings by individuals.

It might just be me, but I am absolutely sure you can read this as being a tax incentive for the financial services industry.

And what a great incentive it is.

There is something in it for the clients (less tax and more money in their pocket), something for advisers and investment managers (faster accumulation of funds by our clients) and finally, something for the government (a greater pool of savings with which to grow the economy, which in turn will generate more tax revenue).

At this point I had to ask myself why, if the answer was so obvious, is the answer not rolling off every audience member's tongue?

I guess this is where I have to stand up and take some responsibility. I have written many articles and done various media interviews about the tax benefits that relate to PIE funds. In these, I have gone into complicated explanations about how, for a 39% taxpayer, PIE lifts their net return by some 14.75%.

There have been lots of tables highlighting things, like for an investor on a 39% marginal tax rate, 8% from a PIE is like earning 9.18% from a normal investment. But I don't think I have ever explicitly promoted the simple fact that the PIE regime provides investors with tax incentives. And this is a primary purpose of PIE – pure and simple. It is not some loophole that the government intends to fix.

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This is where Mum comes back into the picture. Just because something is obvious to you, don't expect other people to do mental gymnastics and understand your punchline.

Despite the current investment environment, I think Cullen might look at the fund flow data into the managed funds industry at the moment and wonder what he has to do beyond tax incentives to get people to save.

To Cullen I say: Be patient. You have set up a fantastic platform to get people to save into PIE funds. People will ultimately be 'money rational' and move to using PIE funds. This is

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because you have given them a tax incentive to do so. It simply takes time to change conventional wisdom.

Despite everything, investors are rapidly getting to grips with the tax incentives provided by PIE funds. The banks are doing a great job educating them. Banks such as RaboPlus are promoting a PIE cash fund they offer as providing 'significant tax breaks'.

A simple message that perhaps I should have stated outright as it applies for most investors in all PIE managed funds. I estimate that nearly $1.5 billion of retail investors' money has been put into cash PIE funds in the last 10 weeks (let's hope that the people who measure fund flows into our industry capture this fantastic news). My best estimate is that this money must belong to 30,000 to 40,000 individual investors, who now get the fact that PIE funds offer them a tax incentive or, in RaboPlus' words, a tax break.

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Perhaps one reason that the simple tax incentive message hasn't got through in our industry is due to the old adage that tax shouldn't influence investment decisions. This maxim definitely doesn't apply here.

Through PIE funds, investors (and their advisers) can structure efficient portfolios that capture the tax incentive now available. This doesn't come at the cost of having to implement some type of dodgy sub-optimal portfolio structure. In fact, I would argue the complete opposite has happened. The removal of the tax disincentives that used to plague managed funds means PIE funds provide investors and their advisers with access to far more robust mainstream investment solutions.

I guess if tax incentives don't work, Cullen could always take a leaf out of Oleg Blokhin's book from the 2006 Soccer World Cup. The Ukraine soccer coach used sex as an incentive, promising to waive the squad's celibacy rule if the team got to the semi-finals. He famously assured players that they wouldn't even have any choice in the matter: "Those who don't feel like it, I'll just drag to their wives".

I am sure that tax incentives will work, and we will see a big growth in savings in PIE funds in the future.

Hopefully Cullen will not have to resort to Blokhin's interesting incentive system. Cullen's regime will ultimately be seen as a success, whereas Blokhin's team will soon be forgotten for their disappointing loss to Italy in the quarter finals. The bizarre thing is that the Ukraine team probably got to enjoy their promised reward despite never having achieved the goal Blokhin set them.

Advisers and their clients should remember though that you can't get Cullen's reward – tax incentives – without meeting Cullen's goal to get more New Zealanders saving and investing in PIE funds. A

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From the CCH tax analysts

QUESTION

X is a developer of property and "spec" homes. The downturn in the property market means the developer wishes to rent properties out for the long term (and as part of a retirement plan).

X intends to sell the properties to a loss attributing qualifying company (LAQC) owned by the him and his wife personally.

Will any subsequent sale of the properties by the LAQC be subject to the "tainting" rules in the Income Tax Act governing land sales, with the proceeds of the subsequent sale taxable to the LAQC?

ANSWER

It is assumed that:
- X is an individual and carried on his or her development business as a sole trader;
- either X or his wife will hold 50% of the shares in the LAQC
- the properties which will be purchased by the LAQC were developed and built by X's development/building business.

Crucially, because X is a person subject to income tax under s CB 7 and the properties will be transferred to an associated party (the LAQC), the LAQC will be tainted by the tax status of X as transferor.

Essentially, the LAQC is put into the same tax position as X. Therefore, because the sale of the properties would have been taxable to X had they been retained and disposed of by him, this means the sale of the properties by the LAQC will also be taxable.

Analysis:
Reference: Income Tax Act 2007 s CB 7, CB 15,
2008 New Zealand Master Tax Guide ¶7-430