# Bite me

## What dead sharks can teach investors

**Investing directly into New Zealand and (certain) Australian shares can leave your clients at risk of a nasty bite from the taxman, according to AMP Capital's Anthony Edmonds**

By Anthony Edmonds

Have you ever seen the videos where people get bitten by dead sharks? They normally involve some crazy fisherman who puts their hand into a dead shark's mouth… and CHOMP, the (already dead) hunted becomes the hunter.

If only those people had read page 238 of *A Field Guide to Coral Reefs*, they would have known that touching a not-long dead shark's tooth triggers a reflex response which results in the shark's jaw snapping shut. Given the force of a shark's bite has been measured at around 3,000 kg/cm2, this is messy.

If you ever catch a shark and feel compelled to put body parts in its mouth, use your mate's hand instead.

So where is the link to tax and funds management? Easy. I think that advising clients to hold direct portfolios of New Zealand shares with the advent of the portfolio investment entity (PIE) regime is similar to sticking your mate's hands in a dead shark's mouth. It's risky and kind of interesting, but there is no real upside and it could end with blood everywhere.

### PIE New Zealand shares fund – no risk of clients paying tax on capital gains

Why? Well, with PIE, advisers can now guarantee that their clients will not have to pay tax on capital gains when they invest in a PIE-managed fund of New Zealand (and certain Australian) shares.

These types of funds are specifically exempt from paying tax on capital gains, and the dividend income is the only return component that is taxed.

In addition, an investor in this type of fund also receives all the usual benefits of investing in a PIE, including having tax from their investment capped at 30%. This is obviously an advantage for investors on marginal tax rates of 39% and 33%.

### Holding New Zealand shares directly – more risk of capital gains tax

But advisers can't guarantee with any certainty that clients who invest in a direct portfolio of New Zealand shares won't have to pay tax on capital gains.



GOOD RETURNS .co.nz

Read this article to earn CPD points
Visit www.assetmagazine.co.nz to find out how

The old tax rules still apply to individuals holding New Zealand shares directly. Under this regime, investors elect to be taxed on either 'capital account' (where they would only pay tax on dividends) or 'revenue account' (where the investor would pay tax on both the dividends and the capital gains).

In my time in the financial services industry, nearly every individual I have ever met uses the capital account methodology when determining what tax to pay on their directly-held New Zealand shares. And this seems fair, as the underlying New Zealand companies have already paid tax on their earnings.

## When would capital gains tax apply?

So, what tests are involved in determining whether a client should pay tax on capital gains? This is an interesting area. I believe many people think that the IRD would look at the level of transactions an investor did to assess whether they were a trader.

In fact, the level of transactions is not necessarily relevant, and normally when I hear reference to this type of trader notion, warning bells go off. This is a sign that people don't actually understand the rules.

The real test to determine whether someone is liable for capital gains is around intent. Specifically there are two main instances in which a gain on the sale of a share is taxable: These are if the share is acquired for the purpose of resale, or; where the taxpayer is in the business of buying and selling such assets.

As such, and assuming the individual is not in the business of buying and selling shares, where an individual acquires shares for their dividend yield, this would result in untaxed gains. Whereas purchasing shares for their capital yield would result in gains being considered as taxable.

Under the same tax rules that apply today for individuals, managed funds in the pre-PIE era provided for tax on capital gains. Given the managed funds were in the business of investing, it was impossible to pretend that the intention in holding the shares was anything but to make a gain over time.

In a similar way an individual or adviser could unwittingly create a trail of documents and evidence that might lead the IRD to determine their intent was to make a gain, and therefore conclude that they should pay tax on the capital gains associated with holding New Zealand shares.

So can one categorically claim that an individual who holds shares directly won't ever get clobbered for tax on capital gains? As part of my research for this article I was unsurprised by all the people who told me individuals would never get made to pay tax on capital gains.

I was completely surprised, however, by how many of these same people kept detailed records of the reasons, other than making a profit, about why they personally had bought and sold shares.

If they don't think there is any risk of paying capital gains tax, why do they go to the trouble of taking this extra precaution to prove they are not trading? So why in the age of PIE would an adviser recommend their clients take an additional risk and invest in New Zealand shares directly?

**I think that advising clients to hold direct portfolios of New Zealand shares with the advent of the portfolio investment entity (PIE) regime is similar to sticking your mate's hands in a dead shark's mouth**

## The fee myth debunked – tax benefits of PIE offset management fees

Before those advocates for direct shares start arguing about the fees for managed funds as a reason for holding New Zealand shares directly, I would like to point out that the uplift in net return as demonstrated below is enough to offset the fees inside New Zealand PIE shares funds (at least the ones I sell).

Let's assume an investor has a marginal tax rate of 39% and the dividend yield of the New Zealand sharemarket averages 6% per year. Because PIE tax is capped at 30%, the net return the investor received is enhanced by approximately 0.54% per year on a net of tax basis versus holding shares directly. To think of this another way, this is like increasing the long-term dividend yield from 6% to 6.9% per year. Significant.

In addition, investors also get the other benefits of investing in managed funds. These benefits include the opportunity for added-value as fund managers are focused on generating higher returns than the market – above and beyond fees. Investing in managed funds is generally simpler with the fund manager taking care of most of the paperwork and investors get diversification and access to rare opportunities with less money, because their money is pooled.

In addition, investing directly in shares is not without costs and fees, and there are other attractive quirks associated with the PIE regime, including management fees being tax-deductible, while added-value is tax-free.

So, I don't think the fee argument has any weight to it. I think the only legitimate reason for getting clients who are on marginal tax rates of 39% and 33% to invest in shares directly, is if you have a deep conviction that this approach will generate a materially better return than investing in a professionally-managed PIE fund. This conviction might land you (or your clients) in hot water if the Inland Revenue Department ever asks about tax on gains.

## So why take the risk?

Now I want to be clear. I don't think it is likely that an individual will have to pay capital gains tax on their shares (though I guess there are a few residential property investors who are now feeling the pain of having to pay unexpected tax bills!). My key question is why would anyone ever take this risk?

PIEs create certainty that capital gains won't be taxed. They also provide significant tax benefits to many, along with other benefits like access to professional investment managers and active strategies.

However, if I cannot convince you of the benefits of managed funds and PIEs for enhancing returns, then I recommend that, for those clients you advise to invest directly in New Zealand shares, you should have them formally acknowledge that they are happy to carry the tax risks associated with this strategy.

This is no different that getting your mate to sign a waiver of responsibility before they stick their hand in a dead shark's mouth. A