FOR FIF'S SAKE: *Why NZ's global tax rules need a rewrite.*

The treatment of off-shore based investments creates inequities.

BY: Anthony Edmonds

Imagine the outcry from New Zealand farmers if the government provided tax incentives for Kiwis to buy Australian and English lamb. I guarantee my mates Trev, Butch and Porky* would head straight down to Wellington in the Hilux to sort it out, making John Key's claim that the capital city was dying look like an understatement.

Why is it then that us fund manager types aren't marching on the Beehive to overturn the all-too-real tax incentives that encourage New Zealand-resident individuals (IRD speak for "Mum and Dad" investors) to buy offshore-based investments instead of locally-made varieties?

But before we can get the fund manager hikoi on the road, I want to explain the source of these unfair incentives, which are buried deep in the tax rules for global share investments.

Firstly, let's recap the two methods New Zealanders can use to calculate tax on international shares:

- Under the Fair Dividend Rate (FDR) regime, which applies to Portfolio Investment Entities (PIE), an investor's income for tax purposes is assumed as 5%, regardless of the actual result;
- In contrast, where an individual owns offshore shares directly, including via offshore-manufactured global share funds, they are taxed under the Foreign Investment Fund (FIF) regime, where actual gains and losses are taken into account.

This unevenly-applied dual taxation method creates a huge disadvantage for global equity products structured as PIEs, which includes KiwiSaver funds (New Zealand's fastest-growing retail investment pool).

If you assume a Prescribed Investor Rate (PIR) tax rate of 28%, under FDR this results in 1.4% of tax being paid by the investor in a global shares PIE, regardless of the return on the underlying assets. This means that if the investor experiences a gross return of -10%, then after tax this becomes -11.4%.

To me this hardly seems fair (perhaps a better name is the Unfair Dividend Rate or UDR).

Comparatively, the FIF regime has some incredible incentives for individuals holding international equities directly or through foreign-based investment products. As I recall, these tax breaks came about as a result of Dr Cullen looking after his mum when he introduced the FDR regime.

Dr Cullen's tax rule twist was designed to ensure that when returns were negative, individuals (like his mum) did not have to pay FDR tax on offshore shares they held directly or in offshore-manufactured global share funds.

But the PIE-unfriendly rules can boost the returns from foreign funds and direct share investments in another way, too. Under the FIF regime, individuals usually only have to pay tax on their offshore investments based on the value at April 1 (the exception is when the quick sale rules apply).

This means that between April 1 and March 31, FIF-governed investors don't pay tax on their contributions, or on any of the capital gains accumulated during this period.

The opposite is true for domestically-manufactured offshore share PIEs, which must calculate tax based on the daily value of their investment, including contributions and any capital gains.

To return to my opening scenario, these incentives are akin to chopping GST off Australian and English lamb while leaving it in place for Kiwi products: in this case, my mates Trev, Butch and Porky would have that Hilux moving double-quick down to Parliament.

Back in the world of funds management, however, if you put those two above points together (tax on real gains and losses plus only April 1 valuation date for assets for tax purposes), it's clear the FIF rules have created an over-sized tax incentive for offshore-manufactured funds at the expense of domestic ones.

To understand the magnitude of these incentives, let's do a bit of the math. The following table assumes that two individuals (Brian and Sue) invest $100,000 per annum on April 2 in global shares for the next four years. The returns they get in year one, two and four are 10% per annum, while they experience a 5% loss in year three.

The table compares the tax that Brian pays in a FIF fund, with what Sue pays in a global shares PIE fund. Note that both Brian and Sue's marginal tax rate is 33 per cent, meaning they both have a PIR of 28 per cent for the PIE income.

See table on opposite page.

As shown, despite having experienced exactly the same returns, Sue paid **more than twice as much tax** as Brian. This in turn boosted Brian's net return, so that he ended up **with $8,698 more money than Sue**.

This is the natural outcome of taxation system based on unbalanced incentives. Unfortunately, the balance is skewed in favour of foreign investment firms rather than New Zealand fund managers.

Who should care?

Clearly, Kiwi-based fund managers should. The NZ government is supporting the offshore investment fund manufacturers to our detriment. To this end, why not give offshore farmers a hand up too? As a consumer, I would be keen on getting my hands on some cheaper chops.

Individuals getting pushed into KiwiSaver should care. They end up paying more tax on their global share investments than if invested directly or via an offshore-based FIF fund. In effect, the government is pushing KiwiSavers towards an investment vehicle that provides individuals with a sub-optimum outcome from a tax perspective (mind you – it obviously

	Brian – Offshore-manufactured global share fund taxed under the FIF rules					
	Opening Value at 1 April	Contribution 2 Apr	Return %	Return $	Tax Paid	Closing Value
YEAR 1	$0	$100,000	10%	$10,000	$0	$110,000
YEAR 2	$110,000	$100,000	10%	$21,000	$1,815	$229,185
YEAR 3	$229,185	$100,000	-5%	-16,459	$0	$312,726
YEAR 4	$312,726	$100,000	10%	$41,273	$5,160	$448,838
TOTAL					**$6,975**	**$448,838**

	Sue - Locally manufactured global share fund taxed under FDR rules					
YEAR 1	$0	$100,000	10%	$10,000	$1,470	$108,530
YEAR 2	$108,530	$100,000	10%	$20,853	$3,065	$226,318
YEAR 3	$226,318	$100,000	-5%	-16,316	$4,454	$305,547
YEAR 4	$305,547	$100,000	10%	$40,555	$5,962	$440,141
TOTAL					**$14,951**	**$440,141**

maximizes the government's tax take of your retirement savings).

On this last point, I can't help but question the government's rationale for providing an incentive for offshore-manufactured global share funds (which reduces their tax take), while having higher taxes for locally-manufactured global share funds like KiwiSaver.

The Financial Markets Authority (FMA) should care, as offshore operators can more easily evade its policing efforts compared to domestic funds. As the Ross fiasco highlighted, the reach of the FMA is pretty limited when it comes to the promotion of offshore investments to Kiwi investors. The FMA has probably assumed (incorrectly) that most individuals get exposure to global shares through New Zealand-manufactured global share PIE funds.

Finally, New Zealand businesses should care that we have a tax incentive that steers capital away from the country.

For my part, I have a foot in each camp, as our business is able to offer global share funds as FIFs and also PIE funds. A quick look at our funds under management from retail investors for global shares (through advisers using the wrap platforms) proves just how effective these – as I have demonstrated – misconceived tax incentives are: for every $1 in our PIE global share funds, there is $10 in our comparable FIF global share funds.

Pleasingly, the fact that in the retail market our FIF funds are 10-times as popular as their PIE avatars also highlights that advisers are well on to these incentives and benefits when they are recommending solutions to their clients.

However, as tax-savvy advisers will know, the incentives outlined above are not the only elements investors should consider when analysing global share options.

Local investors using offshore-manufactured global share funds are unable to get an offset for 95% of the management fee against their FDR income. This is a function of the mechanics of the FDR (or, more aptly, UDR) tax rules, which needs to be carefully considered when comparing investment options. For every 1% of management fee this creates a tax inefficiency (slippage) of approximately 0.3% per annum, which is material in anyone's books.

Also, investors need to search for other sources of tax slippage within different global share funds that they use. A good example is the withholding tax deducted on the dividends being paid by the underlying shares. This tends to get trapped within offshore fund structures. If, as a New Zealand taxpayer, you are unable to get any benefit or recognition for this withholding tax, it can have a detrimental impact on returns. Indicatively, this could be a cost of around 15% of the underlying dividends. For a global share fund with a 3% dividend yield, this could be around 0.45% per annum in tax slippage.

As a simple rule of thumb, offshore manufactured funds with higher fees, and/or higher underlying dividend yields, will typically have more tax slippage for Kiwi investors.

It is worth noting that New Zealanders who invest in offshore equities directly have to incorporate the often-considerable cost involved in completing more complex tax returns.

Nonetheless, the sources of slippage and costs outlined above are normally nowhere near significant enough to make up for the big tax incentive that offshore-manufactured global share funds enjoy.

Furthermore, it is possible that these inefficiencies also exist within global share PIEs, which in turn is a function of how well such a fund has been structured.

To muddy the water further, because under FDR PIE tax is calculated at an investor level (meaning that funds don't have net unit prices), these types of tax inefficiencies can be hard to spot. These intricacies and nuances certainly provide some challenges in terms of researching and assessing different types of global share options for retail investors.

What is demonstrably clear, though, is that the significant tax incentives encouraging Kiwi investors to buy offshore-manufactured global share funds and products must be reviewed.

A simple and effective solution to the bias against local funds would be to give global share PIEs the same tax rules as their FIF counterparts.

What would Trev, Butch, and Porky think of the current FIF/FDR discrepancy? They have always had a good nose for managing their tax, as they seem to be forever hiding things in the proverbial "fertilizer bin".

I imagine they would be quick to highlight to Brian, who you will recall followed the FIF path in our example above, that he could be really tax smart by selling all of his global shares in late March of year four. Come April 1 in year five, his holdings in global shares are worth $0 meaning that if he reinvests on April 2, he pays nothing in tax in year five.

Now that seems pretty clever, as it creates further real tax savings. If the farming business falls through, Trev, Butch and Porky, might have great futures as financial advisers.

Disclosure: Anthony Edmonds is the Managing Director of Implemented Investment Solutions Limited (IIS), who is the manager of the Russell Investment Funds (which are Portfolio Investment Entities). IIS also provides advisers with access to various Russell funds that are Foreign Investment Funds for tax purposes.

**Trev, Butch and Porky are real people, although it should be noted that Porky owns a trucking business, and is not a farmer.*