Tax treatment of international investments:
- a complex web with complex outcomes

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When it comes to investing, the return that matters is the after-tax return. Fees and costs are also important. The after-tax return depends in part on the gross return of the investment and also on the way that the investment is bought/held. This paper looks at the range of return outcomes that can arise for two sample cases, an Australian share and an overseas bond, simply because of the way the investment is bought.

This paper is a general explanation and should not be construed as authoritative or as tax advice. There is no guarantee that the tax regimes illustrated are correct. The paper simply illustrates the problems associated with New Zealand's current investment tax regime.

There is, however, a guarantee that the tax regime is complex and distortionary and this is wrong in principle. Investors must check with a tax expert before making any investment decision. That advice also underlines what is wrong with the current environment.

Investment options

When it comes to investing, investors can invest directly, or via a product or pooled vehicle. The pooled product can be a unit trust type of product, or a superannuation scheme type of product, or a 'portfolio investment entity' ("PIE").

A "**unit trust**" type of product passes the return through to the investor and so the taxable income is ultimately taxed at the investor's marginal tax rate. Examples are unit trusts, group investment funds and companies.

In contrast, "**superannuation scheme**" type products are taxed within the product and ultimately distribute the net return as tax-paid capital to the investor. Examples are registered superannuation schemes and insurance bonds. A superannuation scheme type product is a 'final' taxpayer.

A **PIE** vehicle is also a final taxpayer and taxes the investment income within the PIE at the investor's marginal PIR tax rate (Prescribed Investor Rate). PIRs are currently either 19.5% or 30% ("PIR^T") which for most are concessionary rates. PIE vehicles also are taxed for Australasian shares on only their dividends; the capital movement is tax-free. PIE vehicles can be unit trusts or superannuation schemes.

Unit trusts, superannuation schemes, PIEs etc are generally referred to as collective investment vehicles (CIVs) because groups of savers pool their savings with the goal of gaining the advantages of scale and flexibility.

It should also be noted that one product can invest in another product and therefore alter the overall tax basis. For example, a unit trust or superannuation scheme could invest in a PIE. The jurisdiction of the product also influences the tax treatment. For example, an investor investing in a NZ unit trust that owns an Australian share recieves a different tax treatment to that of an investor investing in an Australian unit trust that invests in the same Australian share. Offshore based trusts (including those based in Australia) fall within the Fair Dividend Rate ("FDR") tax regime.

Owning an Australian share

There are at least 11 different ways an investor can invest in BHP Billiton shares. In each case, the gross return is the same, but the net-of-tax return to the New Zealand investor will be different. The gross return of the BHP Billiton share is the dividend (D) together with the market movement (M).

The following analyses the tax treatment of eleven different ways in which an ultimate investment in BHP Billiton shares can be held.

Direct investments

A. **Direct long-term passive investment.** If the investor buys BHP Billiton shares directly, the tax treatment is the capital/revenue regime. Under this regime, if the shares are bought for the long-term, the investor pays tax on the dividends received and benefits from movement in the value of the shares tax-free. The tax rate applicable to the dividends is the investor's personal marginal tax rate (M^T). If the investor has total taxable income above $70,000, this is currently 38%.

$$\text{Return} = ((1 - M^T) \times D) + M$$

B. **Direct active investment.** The investor can buy and sell BHP Billiton shares based on when the investor thinks they will go up and down in value. On this basis, tax is paid both on the dividends received (if any) and the realised gain/loss arising from the market movement. The tax rate is the investor's personal marginal tax rate.

$$\text{Return} = (1 - M^T) \times (D + M)$$

C. **'Direct indirect' investments.** The investor can invest in an Australian unit trust that in turn buys BHP Billiton shares. This shifts the tax calculation to the FDR regime. As such, the investor pays tax at the personal marginal tax rate on a deemed "income" equal to 5% of the value of the investments on 1 April (Value).

$$\text{Return} = D + M - (M^T \times (5\% \times \text{Value}))$$

A subset of this is where the purchase price (or the Value) of the investments is below $50,000 and the *de minimus* rules apply. In this case, the tax liability is on the capital/revenue regime (case A above).

Unit trust investments

D. **NZ unit trust.** If the investor buys units in a NZ unit trust which in turn invests in BHP Billiton, the investor pays tax on essentially the same basis as Case B above. However, while the capital movement and dividends remain within the trust, they are taxed at the trust's rate of 30%. Ultimately, they become distributions from the unit trust and the investor receives an associated imputation credit. In that case, the returns are taxed at the investor's marginal tax rate as income (as for Case B above).

$$\text{Return} = (1 - M^T) \times (D + M)$$

E. **NZ unit trust into a PIE.** As an alternative to investing directly in BHP Billiton shares, the NZ unit trust could invest in a PIE. On this basis, the NZ unit trust temporarily gains the benefits of a PIE: no tax on capital gains and a PIR tax rate of 30%. However, the final tax liability on distribution to the investor is still at the investor's marginal tax rate.

$$\text{Return} = (1 - M^T) \times (D + M)$$

F. **NZ unit trust into Australian unit trust.** As a further alternative, the NZ unit trust could invest in an Australian based unit trust that in turn buys the BHP Billiton shares. The tax treatment for the NZ unit trust under this arrangement comes under the FDR regime. In this case, tax is calculated on 5% of the value of the BHP Billiton shares (i.e the unit trust holding that will presumably reflect the value of the shares) on 1 April each year. A further tax liability arises if the NZ unit trust buys and sells units in the Australian unit trust (which in turn owns BHP Billiton shares) in the same year. While the taxable income to the NZ unit trust is limited to 5% of the opening value of the units, the tax rate ultimately paid by the investor will be the investor's marginal rate (as for Case D above).

$$\text{Return} = (1 - M^T) \times (D + M)$$

Registered superannuation schemes

G. **NZ Registered Superannuation Scheme – passive**. If the investor invests in a registered superannuation scheme that buys BHP Billiton shares and holds the shares on capital account, tax is paid by the scheme at 30% on just the dividends. The net dividends and capital movements are accumulated and do not form part of the investor's income. They effectively become capital or tax-paid returns. The 30% tax does not reflect any investors' personal tax rates (12.5%, 21%, 33% or 38%).

$$\text{Return} = (70\% \times D) + M$$

H. **NZ Registered Superannuation Scheme – active**. If the investor invests in a registered superannuation scheme that buys and sells BHP Billiton shares and does not hold the shares on capital account, tax is paid by the scheme at 30% on the total of the dividends and the capital movement. The net income, after the deduction of the 30% tax, becomes tax-paid capital. There is no flow through to the investor's personal tax.

$$\text{Return} = 70\% \times (D + M)$$

I. **NZ Registered Superannuation Scheme into Australian unit trust.** As an alternative to Case H, the NZ Registered Superannuation Scheme can invest in an Australian unit trust that in turn owns BHP Billiton shares. The tax liability now falls under the FDR regime. The taxable income of the NZ scheme is 5% of the value at 1 April (of the unit trust – that, as before, reflects the BHP value) which is taxed at 30%. The actual return after-tax therefore, becomes the dividends received plus/minus capital movement less 1.5% (i.e. 30% x 5%).

$$\text{Return} = (D + M) - 1.5\%$$

J. **NZ Registered Superannuation Scheme into a PIE.** As an alternative to the NZ Registered Superannuation Scheme buying the BHP Billiton shares directly, it can invest in a PIE that owns the BHP Billiton shares. The taxable income becomes the PIE income (i.e. the dividends) and it is subject to tax at 30% within the PIE. The capital movement is not taxable.

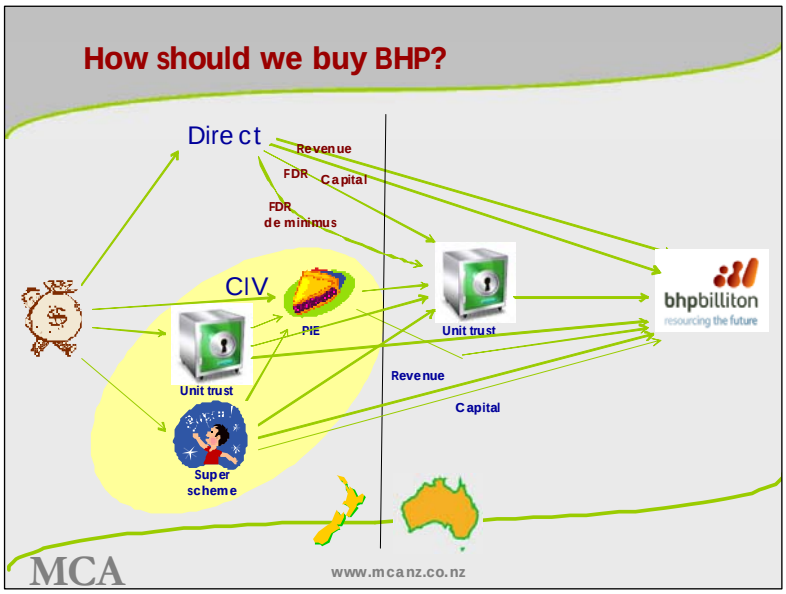
$$\text{Return} = (70\% \times D) + M$$

PIEs

K. **PIE**. If the individual investor invests in a CIV that is a PIE that buys BHP Billiton shares then, whether the PIE holds them on capital account or revenue account, the PIE pays tax at the investor's PIR on the dividends received. There is no tax liability on the capital movement. The investor's PIR rate is either 19.5% or 30% depending on their total taxable income and total PIE income, in the previous two years. In simple terms, if the investor's taxable income was below $38,000 in either of those two financial years, the investor will probably qualify for the 19.5% PIR rate. The PIE tax is a final tax and there are no consequences to the investor provided they chose the correct PIR. PIEs can be unit trusts, superannuation schemes, insurance bonds etc.

$$\text{Return} = ((1 - PIR^T) \times D) + M$$

The different tax treatments and structures can be illustrated as:



So what is the best answer for Australian shares?

The investor should be expected to maximise the after-tax return on the investment in BHP Billiton shares and to arrange that investment accordingly. For an individual, how that is done depends on the marginal tax rate and issues such costs, convenience etc. For most, owning BHP Billiton shares through a PIE or a superannuation scheme that invests in a PIE will be optimal. A unit trust is unlikely to be optimal unless the investor needs taxable income to offset against loses from other sources.

If the dividends of BHP Billiton are less than 5% p.a. then the PIE should own the shares directly. If the dividends are more than 5% p.a., the PIE should own them via an overseas-based vehicle. Historically, the dividends of BHP Billiton have been well below 5% p.a.. Therefore, owning the shares through a PIE or a superannuation scheme that invests in a PIE (for the higher paid) has the potential to result in the best New Zealand net-of-tax and net-of-fees return.

If the shares were not BHP Billiton shares but shares of a company that has had a dividend above 5% p.a. then the same structure makes sense but the vehicle should own the shares via an overseas-based unit trust to come under the FDR regime.

Of the 11 different options A to K, four (B, D, E and F) have the same ultimate tax treatments but the patterns of net returns will differ depending on the relationship between the timings of dividends and market values relative to the 1 April fixing of "Value" for FDR calculations.

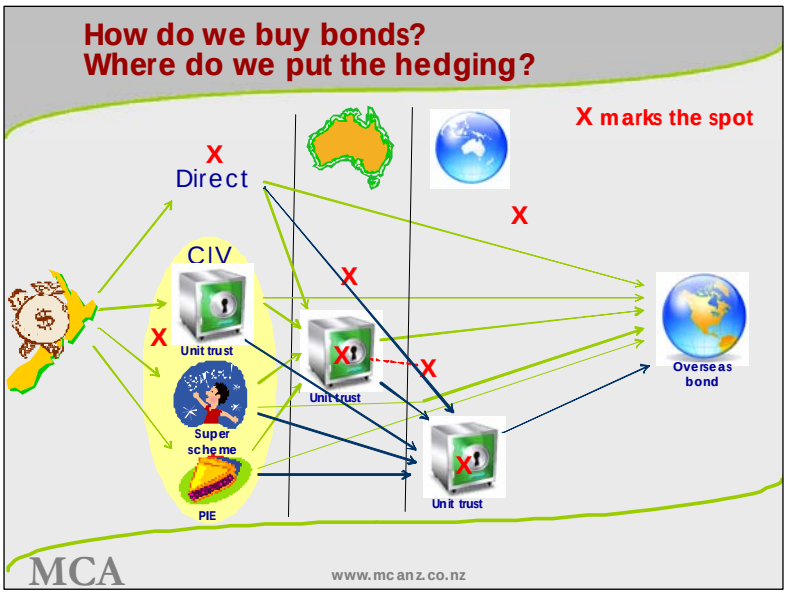
The above discussion ignores the impact of currency management. If currency hedging contracts are also bought to manage the currency risks, that changes the return pre- and post-tax. The optimal NZ vehicles are still the same but, in this case, there are also advantages in looking at an overseas based product that incorporates currency hedging contracts, as this falls under the FDR regime and can be tax efficient.

Owning an overseas bond

There are more than 13 different ways a New Zealand investor can buy an overseas bond. Compared with Australian shares discussed above, the additional ways arise because of currency hedging. In almost all cases, the overseas bonds are hedged. In each case, the gross return is the "same", but the net-of-tax return will be different. The gross return of the overseas bond is the total of the interest from the coupon (I), the market movement (M) and the currency impact (C) or change in the NZ exchange rate.

Investors can buy overseas bonds directly, or invest via a product or pooled vehicle. The pooled product can be a unit trust type product, a superannuation scheme type product, or a PIE. The hedging can be within the pooled vehicle or outside the pooled vehicle.

The different tax treatments and structures can be illustrated as:



The "X marks the spot" is where the currency hedging contracts are placed, i.e. in the product or outside the product, in NZ, Australian or overseas. Also, it must be remembered that when hedging because of tax, there will be times where the level of hedging should be equal to the value of the overseas bonds and times when it should be the value of the bonds divided by '1 less the marginal tax rate'. This effectively hedges the tax payable as well as the return itself. Because of the impact of interest rate differentials this will give a further variation to the net return outcomes.

Direct investment

L. **Direct investment.** If the investor buys the overseas bonds directly, the tax is payable under the accruals regime. This treats any change in value as income (or losses). The tax rate applicable is the investor's personal marginal tax rate (M^T). If the investor has total taxable income of more than $70,000, it is currently 38%.

$$\text{Return} = (1 - M^T) \times (I + M + C)$$

M. **'Direct indirect' investments.** The investor can use an Australian unit trust that in turn buys the overseas bonds. This shifts the tax treatment to the FDR regime. Here the investor pays tax at their marginal personal rate on a deemed income equal to 5% of the value of their investments on 1 April. The net return to the investor also depends on where the currency hedging is held. It can be held separately or in the product. If it is held in the product the net return also depends on where the currency contracts are purchased i.e. in Australia or outside Australia. If purchased in Australia then there will be Australian tax (A^T) to pay on the currency gains.

Hedge held directly by investor
$$\text{Return} = I + M + ((1 - M^T) \times C) - (M^T \times 5\%)$$

or

Hedge held in Australia
$$\text{Return} = I + M + (1 - A^T) \times C - (M^T \times 5\%)$$

or

Hedge held outside Australia
$$\text{Return} = I + M + C - (M^T \times 5\%)$$

A subset of this is where the total cost price (or the Value at 1 April) of the taxpayer's investments is below $50,000 and the *de minimus* rules apply. In this case, the tax liability is on the capital/revenue regime.

A further variation can occur when the overseas unit trust is not based in Australia or the Australian unit trust itself invests in an overseas unit trust. In these cases, the net return is one of the above returns though there may be some tax slippage within the overseas based unit trust.

Unit trust investments

N. **NZ unit trust.** If the investor buys units in a New Zealand unit trust which in turn invests in overseas bonds, the investor pays tax essentially on the same basis as under Case L above. However, while the returns remain within the trust, they are taxed at 30%. Ultimately, they become distributions from the unit trust and the investor receives an associated imputation credit. When withdrawn, the returns are taxed at the investor's marginal tax rate as income.

$$\text{Return} = (1 - M^T) \times (I + M + C)$$

O. **NZ unit trust in Australian unit trust.** As an alternative to investing directly in overseas bonds, the NZ unit trust could invest in an Australian based unit trust or an overseas based unit trust that in turn buys the overseas bonds. The tax treatment of the unit trust under this arrangement becomes the FDR regime. Under this regime, tax is payable on 5% of the value of the unit trust that in turn reflects the value of the overseas bonds on 1 April each year. A further tax liability arises if the NZ unit trust buys/sells units in the Australian/overseas unit trust (overseas bonds) in the same year. While the taxable income is limited to 5% of the value of the unit trust and therefore the overseas bonds, the tax rate ultimately paid will be the investor's marginal rate. Also significant timing issues and tax slippage can occur depending on where the currency is managed. Ultimately the return becomes

$$\text{Return} = (1 - M^T) \times (I + M + C)$$

Registered Superannuation Schemes

P. **NZ Registered Superannuation Scheme.** If the taxpayer invests in an NZ Registered Superannuation Scheme that buys overseas bonds, the tax treatment is the same as for Case L above but the tax rate is now the 30% superannuation scheme rate. The 30% tax does not reflect any investor's personal tax rate.

$$\text{Return} = (1 - 30\%) \times (I + M + C)$$

Q. **NZ Registered Superannuation Scheme in an Australian unit trust.** As an alternative to Case P above, the NZ registered superannuation scheme can invest in an Australian unit trust or an overseas unit trust that owns the overseas bonds. The tax liability falls under the FDR regime and the taxable income is now 5% of the value at 1 April and is taxed at 30%. In addition, the return will be influenced by where the currency contracts are held and bought i.e. held in the product or outside the product and bought in Australia or overseas (outside Australia). The actual return after-tax therefore, becomes the gross return less 1.5% (i.e. 30% x 5%) adjusted for currency. The alternative formulae are:

Hedging held directly by investor

$$\text{Return} = I + M + (1- 30\%) \times C - 1.5\% \times \text{Value}$$

or

Hedging held within product

$$\text{Return} = I + M + C - 1.5\% \times \text{Value}$$

PIE

R. **PIE.** If the investor invests in a CIV that is a PIE and that buys overseas bonds, the PIE pays tax at the investor's PIR on the return. In essence, the return is the same as that of the registered superannuation scheme (Case Q above) except the tax rate is not 30% but the investor's PIR tax rate. The alternative formulae are therefore:

$$\text{Return} = I + M + (1- PIR^T) \times C - PIR^T \times 5\% \times \text{Value}$$

or

$$\text{Return} = I + M + C - PIR^T \times 5\% \times \text{Value}$$

So what is the best answer for overseas bonds?

For an individual, the 'best' answer depends on the investor's marginal tax rate and issues such costs, convenience etc. For most, owning overseas bonds through a PIE or a registered superannuation scheme that invests in an Australian/overseas unit trust and that incorporates the currency purchased overseas will be optimal. This limits the tax to either 30% or the investor's PIR on 5% of the value. As the expected average return from hedged overseas bonds is above 5% p.a., this reduces the effective tax paid. It can reduce the marginal tax rate to between 10% and 16% depending on the investor's PIR. At 30% (the top PIR rate and the rate applicable to registered superannuation schemes) the effective tax rate becomes approximately 15.9%.

But tax should not drive the decisison

In theory, tax should not be the driver of the decision for the implementation of an investment. Unfortunately, the tax structure does drive the decision and the position will become more complicated if the proposed changes introducing a third PIR become law, as proposed from 1 April 2010.

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