Kernel

Guide to Taxation of Foreign Equities for New Zealand Residents

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MyFiduciary

JOHNSTON ASSOCIATES | CHARTERED ACCOUNTANTS

Some Funds Are More Equal Than Others

Overseas investment funds can be attractive for several reasons compared to New Zealand based products. There is a great deal more to choose from, investors can pick from some of the world's best investment managers, and headline fund manager fees are sometimes much lower.

However, in many cases, you will pay more tax than if you invested in a New Zealand product. The extra tax may more than offset any saving in manager fees, leaving you with a lower overall return. For example, consider a typical kiwi wholesale investor who uses a US-listed Exchange Traded Fund (ETF) to invest in international equities. Tax will reduce their long-term return by between 1.7% and 2.3% per annum, due to the foreign withholding taxes and New Zealand's Foreign Investment Funds (FIF) tax rules. If instead they invested in the same global equities, but through an unlisted NZ PIE, the tax drag would be only around 1.4% per annum.

The table below summarises the return drag due to tax for the most common investment vehicles used by New Zealanders. We note that every investor is different, and the tax impact depends on their circumstances. It also depends on many underlying assumptions, such as the average dividend yield. But the estimates in this paper are a reasonable guide to what a typical investor might face through different investment structures.[1]

Key Conclusions

- The tax structure matters a lot. For an investor on the top marginal tax rate investing in international equities, tax will reduce your long-term return by between 1.3% and 2.9% depending on how you invest. For Australian equities, the tax drag ranges from 1% to 2.7% per annum.
- A benefit of the Foreign Investment Fund rules is that individuals and trusts can change the calculation method each tax year after calculating their total foreign return. For reasons explained in the paper, the ability to switch FIF calculation methods can reduce the expected annual tax rate paid over a period of years by an average of approximately 0.60% (compared with choosing or having to stick with the Fair Dividend Rate method every year). But, this comes at a cost because the paperwork burden is higher and it may require extra assistance from an accountant or tax adviser.
- If you can't switch from year to year, a NZ unlisted PIE will always be the most tax efficient option. For a tax-paying investor, the saving varies from 0.55% to around 0.9% per annum compared to the other investment options.
- Australian Unit Trusts – which are common in the New Zealand market – may not be tax efficient compared with alternative products. The key reason is that in AUT investors pay tax on their realised capital gains, as well as tax on dividends. The capital gains tax may be delayed for a few years, but it gets paid eventually. The impact on returns is material – e.g. up to 2.9% for international equities if FIF exempt, compared with 1.4% in a PIE.
- Be careful, not all PIEs are the same. A NZ PIE often has a lower tax burden but only if it is directly holding the underlying overseas shares. A feeder fund – e.g. a PIE that just owns an Australian Unit Trust – will usually suffer the same tax drag as the underlying Unit Trust. For example, an investor in a FIF-eligible AUT who can switch methods faces an average tax drag of 1.7%. If they can't switch method, for example because the AUT is wrapped in a PIE by a fund manager, then the tax drag would be around 2.3%.
- The analysis is different for small investors, who can take advantage of the 'de minimis' rules to reduce and simplify the tax they pay on low dividend overseas investments.
- For tax-free investors, the product choice usually makes less difference. However listed ETF PIEs are always taxed at 28% and AUTs are also likely to overtax the non-resident investor.

[1] We have published a calculator to show the impact of changing annual income and total return assumptions. See here.

Table: Typical tax drag from different investment vehicles.

Percent per annum reduction in return.

Type of investment vehicle	Taxable investor paying 39%	Taxable investor paying 33%	Taxable investor paying 17.5%
International equities			
NZ unlisted PIE	1.4	1.4	0.9
Investing directly^	1.3 (0.4-1.9)*	1.2 (0.4-1.7)*	0.7 (0.4-0.9)*
NZ ETF	1.8	1.8	1.3
US ETF or securities via UCITS fund, UCITS ETF, or FIF eligible AUT	1.7 (0.4-2.3)*	~1.5(0.4-2.0)*	1 (0.4-1.3)*
UKIT	2 (0.4-2.6)*	1.7 (0.4-2.3)*	1 (0.4-1.5)*
AUT - FIF exempt	2.9	2.6	1.4
Australian equities			
Australia Unit Trust (AUT) FIF exempt	2.7	2.3	1.2
Australian ETF or AUT FIF eligible	1.4 (1.0-2.0)	1.2 (0.4-1.7)	0.7 (0.4-0.9)
Investing directly^	1	0.8	0.4
NZ 'Australasian equities' PIE fund	1.4	1.4	0.9

Key	
AUT	Australian Unit Trust
ETF	Exchange Traded Fund
PIE	Portfolio Investment Entity - a mutual fund structure in NZ capping tax at 28%
UCITS	A European domiciled mutual fund (normally Luxembourg or Ireland) designed for international cross-border distribution

*The bolded numbers in the table reports the average long-term tax incidence we expect under the different types of investment vehicles. The bracketed range for some structures reflects a lower tax drag in a negative return year, and a higher tax drag in a year with a 5%+ total return. Where a range is shown, the bolded number is the average rate paid over time by someone who can switch FIF methods from year to year. For investors who cannot switch (e.g. an AUT is wrapped inside a PIE) then the tax drag will be the higher figure in brackets.

^ Assumes no quick sale adjustment for securities bought and sold inside a tax year.

In choosing a fund or product you should always consider:

1. How good is the fund manager?
2. Will the fund likely deliver on the type of investment sought?
3. What are the costs i.e fees plus taxes plus transaction costs (brokerage and spreads)?
4. What is the complexity or paperwork burden around tax?

There are trade-offs among all these factors. The key message of this paper is that you should focus not just on manager quality and fees, but on fees plus taxes plus transaction costs. Some overseas products come with lower fees but higher taxes, and the net cost will often be higher for most investors.

Disclaimer

Tax is obviously a complex topic especially when investing internationally. It's an industry unto itself with the permutations plus different and offsetting impacts that may affect any individual. Naturally, per the standard disclaimer, this is not tax advice, but we will cover the topic in sufficient detail for the normal NZ resident investor and adviser's understanding. Dual or transitioning tax residencies or holding US person status are immediate exceptions to generally applicable tax rules discussed in this document. In particular, persons who are transitional tax residents or who are US citizens/persons should seek specialist advice in relation to their personal circumstances. Care has been taken to ensure the information contained in this guide is accurate at the time of publication however, we give no warranty it is error free. The information is intended as guidance only and the authors accept no liability for claims arising directly or indirectly out of reliance placed on the information contained.

1. How are international investments taxed?

When considering international investments there are **three** levels of taxation to consider.

1. The first is withholding tax on dividends received by investors or the fund and whether the investment structure is optimised to ensure the full benefit of the withholding tax is passed through to the ultimate investor to offset against their New Zealand tax payable. The foreign withholding tax is generally at a rate of no more than 15% where the investment is located in a country we have a double tax agreement with. These withholding taxes generate foreign tax credits which can generally be utilised to reduce the New Zealand income tax payable on the income arising from the investment. A refund of foreign tax credits cannot be obtained through a tax return if they are higher than the New Zealand tax payable.

   When investing in some countries (e.g. UK, France, Italy and Hong Kong) there can also be a stamp duty or transaction tax on the purchase and sale of equities. These taxes are charged as a percentage of the transaction value. These taxes are not able to be claimed in New Zealand as foreign tax credits.

2. The second is the tax implications of using an offshore intermediary structure (if not investing direct) and what are its withholding tax obligations in connection with income passed through to the New Zealand resident investors, and the timing of those distributions from the intermediary.

3. The third is the tax due in New Zealand as a tax resident whether under the PIE rules, the FIF rules or as a direct dividend depending on your personal tax circumstances.

As a starting point, by investing overseas there is usually a tax disadvantage, compared to investing in a NZ equity PIE, of more than 0.9% p.a. This is due to the way imputation credit and FIF tax rules operate.

2. New Zealand equities - direct investment vs. investing via a PIE

Tax is payable in New Zealand on New Zealand sourced dividend income. Unless carrying on a business of trading, or acquiring investments with a dominant purpose of disposal (e.g. day trading), capital gains are not subject to income tax in New Zealand. Dividends are taxed at a rate of up to 28% for a PIE and 39% directly, with imputation credits of up to 28% attached. These dividends are on average 70% imputed, so the tax payment on a 3% net dividend, on average is 0.31% through a PIE and 1.46% if directly owned.

Table 1

	Through multi rate PIE fund at 28% PIR		Direct investment at 33% marginal tax rate		Direct investment at 39% marginal tax rate	
Imputation	0%	70%	0%	70%	0%	70%
Invested	$10,000	$10,000	$10,000	$10,000	$10,000	$10,000
Net dividend	3%	3%	3%	3%	3%	3%
Gross dividend	$300.00	$381.67	$300.00	$381.67	$300.00	$381.67
Dividend received	$300.00	$300.00	$300.00	$300.00	$300.00	$300.00
Tax payable	$84.00	$106.87	$99.00	$125.95	$117.00	$148.85
Imputation credits	$0.00	-$81.67	$0.00	-$81.67	$0.00	-$81.67
Tax to pay	$84.00	$25.20	$99.00	$44.28	$117.00	$67.18
Tax rate	28.00%	8.40%	33.00%	14.76%	39.00%	22.39%
As % Investment	0.84%	0.25%	0.99%	0.44%	1.17%	0.67%

3. The tax disadvantage of a NZ fund being Trans-Tasman.

Many NZ fund managers run Australasian / trans-Tasman funds. While this may open up their universe, there is an immediate tax treatment penalty as NZ investors miss out on the franking credits Australian investors receive. This increases the effective tax rate to 50% of the Australian company's profits as laid out below.

This tax dis-advantage within a fund can only be avoided by investing in companies that don't pay a dividend, such as "growth" or highly speculative companies.

Table 2: Tax treatment of NZ PIE fund investing in NZ or Australian company

At company level	**New Zealand company**		**Australian company**	
Income earned	100 (3% div.)		100 (3% div.)	
Tax paid	28		30	
Income after tax	72		70	
Less Australian NRWT			11	
Cash dividend to shareholder	72		59	
Imputation credit	70%, average 20		Unavailable except where NZ sourced income	
Foreign tax credit	0		11	
At investor level	**PIR 28%**	**PIR 17.5%**	**PIR 28%**	**PIR 17.5%**
Gross income	100	100	70	70
PIE tax on gross income	28	17.5	20	12
Less imputation credits	(20)	(20)		
Less foreign tax credit			11	11
Tax payable	8	-2.5	9	1
Net dividend received	72	74.5	50	58
Effective tax rate	**28%**	**25.5%**	**50%**	**42%**

4. When going direct works

An investor directly investing a total of $50,000 or less (acquisition value) in foreign equities, is exempt from the FIF regime. In this scenario, they may treat FIF investments as if they were New Zealand companies, paying income tax on the dividends received, offset by the foreign tax credits received.

If investing solely in international companies that pay little or no dividends (including Australian companies), this may make sense. However, there are some significant pitfalls. The tilt away from dividend paying companies reduces the diversification benefit of investing internationally. Aside from taxes, there are also significant costs with operating a small portfolio which can't be overlooked and may offset the direct tax benefit. These often include materially higher foreign exchange (FX) charges, foreign custody charges, and brokerage costs than what a fund manager, or larger scale investor, faces.

When going direct, an investor has the ability to minimise tax in a year when returns on the entire international portfolio holdings are less than 5% in NZD. The difficulty is that occurs on average around 30% of the time. An investor would need to calculate or pay for the necessary calculations to determine in NZD, after factoring in currency movements in NZD, whether less than 5% total return and exactly how much tax to pay. In all other years, the majority of investors will benefit from the PIE structure, where the tax is calculated using the PIR rates rather than RWT, and having a fund that efficiently claims and uses all international withholding tax credits. This is before the investor considers the additional costs that come with buying direct – brokerage, custody charges, FX margins, etc.

Table 3

	Pros	Cons
Holding direct under $50k cost value	• Only taxed on dividends received at up to 39%	• FX, foreign custody and brokerage costs to consider • Effort to claim FTCs • No claim to Aus. Franking Credits • Single selection • NZ tax obligations calculated at marginal tax rates, not PIR rate.
Holding direct over $50k cost value	• Can calculate using CV method to reduce tax liability to 0.38% (estimate of withholding taxes on 2.5% yield) if total portfolio losses in financial year, or up to 39% of unrealised & realised gains. • Full control	• When portfolio returns over 5%, investor would use 5% FDR. Using 39% flat RWT rate = 1.95% (5%*39%) in most years = 15% more tax in last 10 of 14 years • When FDR method used, an adjustment is required for quick sale gains where equities are bought and sold within the income year • Single selection • No claim to Australian Franking Credits • 40% US Estate tax risk on US equities incl. ETFs over USD60,000 value if held in personal name • FX, foreign custody & brokerage
Holding in NZ unlisted PIE	• Max 1.40% liability less tax credits • Paperwork handled, all FTCs claimed and correct tax paid • No need for accountant	• Must use FDR method. No choice for years where return <5% • No claim to Australian Franking Credits

5. What about AUTs?

Due to Mutual Recognition, there are a number of Australian licensed products that are available and promoted to New Zealand investors. The most popular structure is an Australian Unit Trust, which is best aligned to Australian legislation. In this structure the tax liability on the income of the trust is generally attributed to the unitholders.For New Zealanders, as non-resident unitholders, the trustee withholds 15% as non-resident withholding tax (NRWT). This is claimable as a foreign tax credit against the New Zealand tax liability. The credit allowed cannot exceed the tax payable. However, there is no ability to claim franking credits (broadly equivalent to New Zealand imputation credits) provided by the underlying companies with their dividends.

Most importantly, under Australian tax rules, AUTs must pay out all income they receive, both from dividends and their realised capital gains. This creates an issue for New Zealand resident investors. In effect, the investor pays 39% tax on capital gains if the AUT is exempt from the FIF rules as all distributions from the AUT, regardless of source, will be fully taxable in New Zealand. Capital gains will also be realised by the fund manager when investors enter and leave the funds. Therefore, over time, all AUT returns will end up as income and, for *de minimis* investors, subject to tax.[3] For larger investors, so long as the AUT has an RWT proxy in place and meets a portfolio turnover test where unrealised gains are no more than 4x any realised gains in any income year they may be able to treat the investment as exempt from the FIF regime. This is unlikely for index funds and not useful in most years.

If the AUT is not exempt from the FIF rules and the investor applies the CV or FDR method each year, the NRWT is still likely to overtax the income as it will be deducted on all capital gain and dividend amounts distributed to the New Zealand investor. This is likely to exceed the amount able to be claimed as a tax credit against the FIF income.

Table 4

	Pros	Cons
Australian Unit Trust (AUT)	• Wider choice of funds than available in NZ • Larger scale funds also meaning management fee can be lower • Range of NZ tax methods	• FX, foreign custody and brokerage costs to consider • Effort to claim FTCs • No claim to Aus. Franking Credits • Single selection • NZ tax obligations calculated at marginal tax rates, not PIR rate.
NZ unlisted PIE	• Most tax efficient • Paperwork handled, all FTCs claimed and correct tax paid • No need for accountant	• Careful if just a feeder fund, same issues as AUT • Always FDR

[2]De minimis investors are those with investments less than $50,000, therefore falling out of the FIF rules.

6. Choice at a cost - when is CV better?

Over the last 30 years, one third of the time the March-year total return of the S&P Global 1200 (in NZD) was less than 5%. We take this to be a reasonable benchmark for the portion of time that returns may be less than 5% going forward. In these years, as seen below, there is a tax advantage to using the CV method. In the remain two-thirds of years, the most efficient tax rate will be 1.95% using the FDR method. If we assume this pattern of gain and loss years holds going forward, the ability to switch FIF calculation methods can reduce the expected annual tax rate paid over a period of years by about 0.60% under an assumed dividend rate of 2.5% per annum and 39% tax rate. (Note: also assumes that there are no years between a 0% and 5% return range). This is compared with choosing or having to stick with the FDR method every year. Against this needs to be considered the higher accounting fees, and potentially higher transaction and administration costs.

Table 5:
Dividend Yield 2.50%

Overall FIF tax cost under each tax method	17.5% Tax Rate			33% Tax Rate			39% Tax Rate		
Total return in NZD	Negative	2.50%	7.50%	Negative	2.50%	7.50%	Negative	2.50%	7.50%
Dividend yield	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%	2.50%
FDR method - direct holding	0.88%	0.88%	0.88%	1.65%	1.65%	1.65%	1.95%	1.95%	1.95%
FDR method - via foreign fund causing tax leakage	1.25%	1.25%	1.25%	2.03%	2.03%	2.03%	2.33%	2.33%	2.33%
CV method - direct holding	0.38%*	0.44%	1.31%	0.38%*	0.83%	2.48%	0.38%*	0.98%	2.93%
CV method - via foreign fund causing tax leakage	0.38%	0.82%	1.69%	0.38%*	1.21%	2.86%	0.38%*	1.36%	3.31%
Exempt claiming FTCs (Australian equities)	0.44%	0.44%	0.44%	0.83%	0.83%	0.85%	0.98%	0.98%	0.98%
Exempt claiming FTCs (international through AUT)	0.75%	0.75%	1.62%	1.08%	1.08%	2.73%	1.20%	1.20%	3.15%
FDR method - NZ unlisted PIE	0.88%	0.88%	0.88%	1.40%	1.40%	1.40%	1.40%	1.40%	1.40%

*unclaimable

If the portfolio dividend yield is higher, this election benefit will be lower. For example, if the portfolio produces income of 4.2% or more, a larger amount of tax accrues in either going direct or if there is tax leakage from inaccessible FTCs. An investor or their adviser needs to be aware of the lost net total return from a higher income proportion.

Table 6:
Dividend Yield 4.20%

Overall FIF tax cost under each tax method	17.5% Tax Rate			33% Tax Rate			39% Tax Rate		
Total return in NZD	Negative	2.50%	7.50%	Negative	2.50%	7.50%	Negative	2.50%	7.50%
Dividend yield	4.20%	4.20%	4.20%	4.20%	4.20%	4.20%	4.20%	4.20%	4.20%
FDR method - direct holding	0.88%	0.88%	0.88%	1.95%	1.95%	1.95%	1.95%	1.95%	1.95%
FDR method - via foreign fund causing tax leakage	1.25%	1.25%	1.25%	2.33%	2.33%	2.33%	2.33%	2.33%	2.33%
CV method - direct holding	0.63%*	0.44%	1.31%	0.63%*	0.98%	2.93%	0.63%*	0.98%	2.93%
CV method - via foreign fund causing tax leakage	0.63%	1.07%	1.94%	0.63%*	1.61%	3.56%	0.63%*	1.61%	3.56%
Exempt claiming FTCs (Australian equities)	0.74%	0.74%	0.74%	1.39%	1.39%	1.39%	1.64%	1.64%	1.64%
Exempt claiming FTCs (international through AUT)	1.25%	1.25%	1.83%	1.81%	1.81%	2.90%	2.02%	2.02%	3.31%
FDR method - NZ unlisted PIE	0.88%	0.88%	0.88%	1.40%	1.40%	1.40%	1.40%	1.40%	1.40%

*unclaimable

7. Summarising the tax elements

The table below shows the headline tax impact of the common options for New Zealand tax residents on the basis those persons are not dual tax residents or US persons. It assumes that all FTC that can be obtained are included on a tax return. The assumption throughout is an average portfolio dividend of 2.50% and 7% average Total Return (TR) with two-thirds of years earning a 5% or more total return (which aligns to MyFiduciary's long term equity return assumptions). The final column shows the total tax impost both as a range based on the total return, and as the long-run expected value based on actuarial assumptions. A glossary on page 10 lists the acronyms used in the table.

Table 7: Tax impact of the common international equity options for New Zealand tax residents

	Withholding on company dividends*	Withholding on foreign fund distributions and tax payable by intermediary	New Zealand tax in year of positive return 17.5% to 39%	Marginal tax rate	Total Tax p.a.	Long term average p.a.
Australian equities[3] via FIF exempt AUT	None	All realised capital gains must be distributed (eventually) as income with 15% NRWT deducted. Total 1.05%	Marginal tax rate for all amounts received 1.23% - 2.73%, reduced by FTC of 1.05%. Estimated net NZ tax payable 0.18% - 1.68%.	39%	2.73%	2.73%
				33%	2.31%	2.31%
				17.5%	1.23%	1.23%
Australian equities via Australian listed ETF or FIF eligible AUT	None	All realised capital gains must be distributed (eventually) as income with 15% NRWT deducted. Total 1.05%	Marginal tax rate on FIF Income 0.88% - 1.95%. Reduced by FTC of 1.05%. Estimated NZ tax cost 0% - 0.90%	39%	1.05% - 1.95%	1.65%
				33%	1.05% - 1.65%	1.45%
				17.5%	1.05%	1.05%
Australian equities[4] direct	15% NRWT usable as FTC. Total 0.38%. Franking credits unusable by NZ residents	N/A	Marginal tax rate on dividend income 0.44% - 0.98% less 0.38% NRWT. Estimated NZ tax cost 0.06% - 0.60%. No claim to franking credits.	39%	0.98%	0.98%
				33%	0.83%	0.83%
				17.5%	0.44%	0.44%
US equities in US listed ETF or unlisted fund	No withholding for US ETF	15% with W8 (total 0.38%) otherwise 30% NRWT on distribution received (total 0.75%) . Can be claimed as FTC. Potential for 40% US Estate taxes on death of individual.	Marginal tax rate on FIF income 0.88% - 1.95%. Reduced by FTC of 0.38%. Estimated NZ cost 0.5% - 1.58%.	39%	0.38% -1.95%	1.43%
				33%	0.38% - 1.65%	1.23%
				17.5%	0.38% – 0.88%	0.71%
US & international equities direct	15% treaty rate if correct paperwork completed for each country held. Total 0.38%. Claimable as FTCs.	N/A	Marginal tax rate on FIF income 0.88% -1.95%. Reduced by FTC of 0.38%. Estimated NZ cost 0.5% - 1.58%.	39%	0.38% -1.95%	1.43%
				33%	0.38% - 1.65%	1.23%
				17.5%	0.38% - 0.88%	0.71%
International equities via US listed ETF or FIF eligible AUT	Tax Opaque. 15% treaty rate if correct paperwork completed for each country held. Total 0.38%. Unable to be claimed as tax credit in NZ, but reduces total taxable income by 0.38%.	15% on dividends with W8 otherwise 30% NRWT on distribution received. Can be claimed as 0.32% FTC. Potential for 40% US Estate taxes on death of individual.	Marginal tax rate on FIF income 0.88% -1.95% less FTC of 0.32%. Estimated NZ cost of 0.56% - 1.63%.	39%	0.69%-2.33%	1.78%
				33%	0.69% - 2.03%	1.58%
				17.5%	0.69% - 1.25%	1.06%
International equities via UCITS ETF	Tax Opaque. 15% treaty rate if correct paperwork completed for each country held. Total 0.38%. Unable to be claimed as tax credit in NZ, but reduces total taxable income by 0.38%.	UCITS design = None	Marginal tax rate on FIF income 0.88% - 1.95%. No tax credits to claim.	39%	0.38% - 2.33%	1.68%
				33%	0.38% - 2.03%	1.48%
				17.5%	0.38% - 1.25%	0.95%

[3] FIF exempt Australian equities
[4] If 30% withheld, will be limited to a 15% claim for New Zealand income tax return. AUT charge 15% NRWT.

*Disclaimer: For simplicity we have assumed a 15% NRWT rate on all company dividends for international equities. We note that whether withholding tax is deducted at source on dividends will depend on the tax rules in the countries the underlying investments are held in which make up of the basket of international equities.

Table 7 continued: Tax impact of the common international equity options for New Zealand tax residents

	Withholding on company dividends	Withholding on foreign fund distributions and tax payable by intermediary	New Zealand tax in year of positive return 17.5% to 39%	Marginal tax rate	Total Tax p.a.	Long term average p.a.
International equities via FIF exempt AUT	Tax Opaque. 15% treaty rate if correct paperwork completed for each country held. Total 0.38%. Unable to be claimed as tax credit in NZ, but reduces total taxable income by 0.38%.	All realised capital gains must be distributed (eventually) as income with 15% NRWT. Total NRWT 0.99%.	Marginal tax rate on 6.62% (7%-0.38% leakage). Total 1.16% - 2.58%. Less FTC claimable 0.99%. Estimated NZ tax cost 0.17% - 1.59%	39%	2.96%	2.96%
				33%	2.56%	2.56%
				17.5%	1.53%	1.53%
International equities via a FIF UKIT	Tax Opaque. 15% treaty rate if correct paperwork completed for each country held. Total 0.38%. Unable to be claimed as tax credit in NZ, but reduces total taxable income by 0.38%.	UKITs design = none	Marginal tax rate on FIF income 0.88% - 1.95%. No tax credits to claim.	39%	0.38%-2.58%	1.68%
				33%	0.38% - 2.28%	1.48%
				17.5%	0.38% - 1.5%	0.95%
International equities via NZ ETF using intermediate entity	Tax Opaque. 15% treaty rate if correct paperwork completed for each country held. Total 0.38%. Unable to be claimed as tax credit in NZ.	NZ ETF pays tax at 28% using FDR method, total 1.4% and unable to claim tax credit.	Dividends either fully imputed at 28%, with no further tax payable or non-imputed and exempt.	39%	1.78%	1.78%
				33%	1.78%	1.78%
				17.5%	1.26%[5]	1.26%
International equities via NZ unlisted PIE	15% treaty rate claimable as foreign tax credits. All paperwork by fund and fund administrator.	None.	PIR to max. 28% on FDR 5% deemed dividend. Less FTC of 0.38%. Estimated NZ tax cost 0.15% - 1.02%. Fund does all filing. No choice of method.	28%	1.40%	1.40%
				17.5%	0.88%	0.88%
				10.5%	0.53%	0.53%

Table 8: By comparison where dividends are assumed to be 70% imputed.

	Tax credits	Intermediary structure tax	New Zealand Tax	Total tax p.a. when investor on 39% tax rate
NZ equities via unlisted PIE	70% Imputation Credits (IC) passed through	None.	Investor chosen PIR (0%, 10.5%, 17.5%, 28%) on 2.5% dividend offset by IC's received.	At 28% PIR an estimated 0.21% net paid following April, or at exit. Less at lower PIR and refunds possible.
NZ equities via NZ listed PIE (ETF)	Imputation Credits (IC) collected in ICA	Tax payable on income at 28%. ICs attached to 28%	None.	Estimated 0.21% net paid as arises.
NZ equities direct	Imputation Credits (IC) passed through	N/A	39% offset by IC	Estimated 0.56% net.

[5]This assumes excess imputation credits may be used against other income to reduce overall tax liability down.

8. Does the same leakage apply to bond investments?

The NZ tax treatment of offshore bonds is straight-forward compared to equities. Bonds are taxed under the financial arrangement regime, meaning the total return over the tax year is multiplied by the investor's applicable marginal tax rate to calculate the NZ tax obligation with all gains being taxable, whether income or capital.

As with listed equities, we can think of the total return from a bond as being the sum of its income return (its bond yield) and its capital gain. The latter for bonds is driven by bonds being re-priced lower or higher as interest rates or credit spreads change relative to what was "priced in" when the bond was purchased. Unlike equities, however, such gains are a relatively small part of the total return a bond holder will receive, particularly over the medium to longer term where in theory the return on a bond held to maturity will just reflect its starting income yield (assuming there is no default by the bond issuer).

For a bond fund, the total return picture is a little more complicated as a manager may add value from actively managing its portfolio and/or from rolling individually held bonds before they mature into newly issued bonds. Most offshore bond funds offered to NZ investors are also hedged to the NZD to remove the impact of currency volatility on bond returns. This in turn implies hedging gains and losses and a carry "pick up" (higher yield) to the extent the NZ short-term interest rates are systematically higher than offshore rates.

However, for the purpose of illustration, we assume in the table below that the return from a bond fund is just equal to its starting yield. At the time of writing, the yield on the most widely followed global investment grade bond index for NZ investors (the Bloomberg Global Aggregate Bond Index NZD hedged) was around 5%. The table below provides an estimate of an investor's tax obligations under a PIE invested directly in bonds, and individual invested directly in bonds and an investment in an AUT or offshore listed ETF that is invested in bonds with a 5% yield. We have also assumed 10% foreign withholding tax is withheld on all interest payments for global bonds. We see that a non-PIE structure reduces the investors return from 0.1% to 0.55% for tax rates between 30% to 39%.

Table 9

Investor's tax rate	**Unlisted PIE fund rate**	**PIE tax on 5% total return**	**Tax on directly held offshore bonds**	**Tax on bonds held via an AUT or offshore ETF given 5% total return[6]**	**Tax difference with PIE for directly held bonds**	**Tax difference with PIE for bonds held via an offshore FIF**
39%	28%	1.40%	1.95%	2.26%	0.55%	0.86%
33%	28%	1.40%	1.65%	1.99%	0.25%	0.59%
30%	28%	1.40%	1.50%	1.85%	0.10%	0.45%
17.50%	17.50%	0.88%	0.88%	1.29%	0.00%	0.41%
10.50%	10.50%	0.53%	0.53%	0.97%	0.00%	0.45%
0.00%	0.00%	0.00%	0.00%	0.50%	0.00%	0.50%

[6]Calculation is simplified for demonstration purposes and assumes 5% FDR method used where applicable and NRWT of 10% withheld at source on all coupon payments. For bonds held via overseas structures rather than direct, the same tax leakage as equities described in this article apply, with slightly less tax leakage as the NRWT rate on global bonds is generally 10% as opposed to the 15% on equities.

9. NZ 0% PIR investor (e.g. Charitable Trusts)

For investors that are tax exempt (0% PIR) such as charitable trusts, or who have tax losses, the foreign tax credits are not usable as there is no NZ tax paid to offset against. The tax charity isn't entitled to be credited for excess tax credits or attributed loss at the Multi-rate PIE level (IR860).

In effect, the NZ government won't refund tax already paid to a foreign government. In this situation, it is important to choose a structure with the least foreign withholding tax paid. The tax leakage from a US ETF or NZ feeder to a UCITS will be the same as the unusable tax credits from a NZ unlisted PIE investing directly. The latter however will allow the tax credits to be received even if they may not be able to be used. An AUT is unlikely to be efficient due to the requirement to distribute (and withhold at 15%) realised capital gains.

Where the investor is a NZ company, the PIR is 0% and therefore the choice of FIF tax method is unnecessary. However, while a foreign tax credit may be claimed to reduce New Zealand tax payable in the company, to the extent a foreign tax credit is claimed, imputation credits would not be generated by the company. This means when dividends are ultimately passed out of the company, there would normally be insufficient imputation credits to fully impute those dividends, meaning additional tax costs (RWT) in relation to those dividends.

10. Conclusion

Tax is but one consideration of choosing an investment, however as we demonstrate in this paper, it is not one that should be overlooked. The use of a direct holding unlisted NZ PIE provides the greatest certainty and least amount of associated cost. There are always scenarios that can be constructed where another method might have advantages, but the disadvantages and effort required especially over longer time periods should be carefully considered.

Authors and Acknowledgement

Kernel Wealth provides unlisted PIE funds optimised for the NZ resident investor. We would be happy to discuss our existing funds, your and your client's needs, and any questions or alternative interpretations you may have.

MyFiduciary provides consultancy services to wholesale investors, including Advisers and various Trusts.

With thanks to private wealth tax specialists Katrina Scorrar and Mark Davies of Johnston & Associates. www.jacalsouthisland.nz

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10. Glossary

Australian Unit Trust (AUT)
An Australian registered entity commonly used to hold an investment portfolio as a collective investment vehicle. Generally this will be treated as a FIF unless certain criteria are met for a FIF exemption. In order to qualify for an exemption from the FIF rules it must have elected to be an “RWT proxy” and meet the 25% minimum turnover test or 70% minimum distribution test (Income Tax Act 2007 EX32).

Capital Gains Tax (CGT)
Tax on the increase in value of an asset. New Zealand is frequently held out as a country which has no Capital Gains Tax. However many types of gains which would normally be regarded as capital in nature are subject to income tax in New Zealand under specific income tax rules. In particular positions bought and sold within a relatively short time frame, or when the investor has a trading intention, would be expected to give rise to taxable gains (or losses).

Comparable Value (CV)
Another method available to an individual investor to calculate taxable income arising from FIF investments, where the investor is not investing through a PIE fund. Under the CV method taxable income is calculated on the change in total portfolio value in a year. This effectively amounts to a tax on unrealised capital gains, offset by available Foreign Tax Credits, instead of an income tax. In years where the total average portfolio balance increases less than 5%, this may work out to be more tax efficient than FDR, however the costs of preparation, transactions and ownership should be seriously considered.

“De minimis” threshold/ FIF - exempt
If a natural person investor holds less than $50,000 of FIF investments, they can treat the FIF investments as if they were New Zealand companies, paying income tax on the dividends received offset by the foreign tax credits received. There are other costs and implications associated that may make this less attractive than it seems. In this paper when calculating FIF comparisons we have assumed an investment over $50,000.

Fair Dividend Rate (FDR)
One of the methods of calculating the New Zealand tax payable from a FIF investment, and the only calculation method available to a PIE fund. The average value of the investment during the year, calculated daily by a fund, is taxed at a fixed 5% multiplied by the investor’s tax rate (or PIR for an investment via a PIE fund). This is a flat rate of taxation to a maximum 1.4% through a fund (28% PIR) or 1.95% if investing directly (investor assumed to be taxable at a rate of 39%) regardless of the profitability or dividends of the company or capital gains or losses. This can be offset by foreign tax credits to the extent they can be recognised. It is usually the best treatment in a year to March where total return exceeds 5%.

Foreign Investment Fund (FIF)
A category of investment which has its own specific tax rules and includes investment in any foreign company or unit trust. FIFs do not generally include debt instruments.

Foreign Tax Credits (FTC)
The amount withheld as NRWT may be able to be filed on a NZ tax return as a credit against NZ tax payable on the income, recognising tax already paid to a foreign government. It is often lost if there is an intermediate entity as it will not flow through to the investor, and this leads to double taxation of some income.

10. Glossary

Term	Definition
Franking Credits	The Australian equivalent of ICs, not identical but broadly the same concept. New Zealand resident investors cannot claim franking credits, so in effect there is double taxation of Australian company profits.
Imputation Credits (ICs)	These are tax credits attached to dividends paid by a New Zealand company (and some Australian companies who have New Zealand profits) to provide a tax credit to shareholders for the company tax they already paid on New Zealand profits being distributed. This is to avoid "double" taxation for New Zealand resident investors. The company can attach tax credits up to 28% of the dividend amount - this is known as fully imputed (100%)¬¬. While many companies fully impute, the New Zealand average is 70% imputed, mainly due to realised capital gains and/or the distribution of foreign profits forming part of the company's taxable income.
Imputation Credit Account (ICA)	A ledger kept by a fund manager of Imputation Credits collected and able to be attached to a fund distribution for use by NZ resident investors. There can be leakage as part of the fund income may not be distributed e.g. fees and charges, and timing issues between ex-date and payment date.
Non-resident withholding tax (NRWT)	Share registries or custodians depending on the country are required, as withholding agent, to also withhold a percentage of the dividend from non-resident /foreign shareholders at payment date. This foreign tax paid can then be recognised by a New Zealand investor as a foreign tax credit (FTC) on a tax return. The average withholding is 30%. A non-resident investor can request this is reduced, normally to 15%, if there is a tax treaty between the countries. If buying through an intermediary, (e.g. a foreign fund, AUT, or feeder fund structure) this withholding may not be claimable in the investor's country as a credit for tax already paid as the credit is received by the intermediary not the investor directly. This can create "tax leakage".
Prescribed Investor rate (PIR)	This is the tax rate payable by an investor in a PIE fund. It is a rate based on the lower of past two tax years' taxable income. The maximum rate for those usually earning income over $48,000p.a. is 28%, which is lower than the 39% payable as income tax on direct investments into foreign companies and/or foreign funds.
Resident Withholding Tax (RWT)	The tax withheld from dividends paid by a New Zealand company to shareholders. This tax paid can then be claimed as a tax credit in a tax return and is refundable to the extent it results in overpaid tax.
Tax Leakage	This is when foreign tax paid on dividend income is unable to be used by the investor in their New Zealand tax return to reduce their New Zealand tax payable on the same income. For example, at a 3% average dividend yield, even if reduced to the treaty rate, due to investing through an inefficient product, 0.38% p.a. of return is lost (15% unclaimed credits * 2.5% dividend). If the dividend is 5%, the leakage would be 0.75%.
United Kingdom Investment Trust (UKIT)	Is a registered investment company incorporated in the UK and listed on the stock exchange. Investment Trusts are usually exempt on capital gains made provided certain criteria are met and other income, such as dividends are generally taxed at the current corporation tax rate in the UK.

10. Glossary

Undertakings for Collective Investment in Transferable Equities (UCITS)	UCITS are investment funds, regulated at a European Union (EU) level. In creating a set of common rules and regulations it allows such funds to seek a single authorisation in one EU member state, and to register for sale and market across EU member states.
Total Return (TR	The increase in an investment's value including dividends/ distributions reinvested. This is regardless of whether realised or unrealised capital gain.
Withholding tax	Tax deducted before distributing to investor. It is up to the investor to clearly nominate their tax number, withholding treatment and whether they are resident or non-resident.