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One of the least understood aspects of KiwiSaver is the entirely new tax code that was designed to go with it. After returns, the level of tax investors pay is the single biggest determinant of how quickly investments grow. In fact, tax should be considered just as important as returns because investors cannot work out what their return is going to be until they have estimated their tax.

Tax complexity is itself a kind of tax. Most investors find tax too confusing to unravel, and as a result, pay far more tax than is necessary over their lifetime. However, all that investors need to know about New Zealand's new investment tax regime can be explained in a paragraph or two.

All KiwiSaver providers are required to use Portfolio Investment Entities, or as they are commonly known, 'PIEs'. All investors fall into one of four PIE tax brackets, which from 1 April 2010 have been set at either: 0%, 12.5%, 21% or 30%. Depending on an investor's personal income level, they must nominate a bracket. Importantly, no investor, irrespective of how much they earn personally, need pay more than 30% tax on their investments. In fact, as the PIE tax rates are so attractive, it is not just KiwiSaver providers who are using PIEs but many banks and managed funds as well.

What is less understood is that the tax rules for each of the major asset classes have also been changed.

Investors will know all too well that the attractive looking interest rate advertised in the window of a bank, or when buying a bond is not the rate they receive after investing for a year. This is because tax must be subtracted. But how many investors are aware that if they invest in shares, or New Zealand listed property, they pay little or no tax at all?

This means investors need to consider both the merits of the asset class they are investing in – such as term deposits, bonds or shares – as well as the amount of the return which is taxed. The following table brings the PIE tax rules together with the different tax rules that apply for each type of investment. It is a helpful summary of all that investors need to consider when determining what their after-tax return will be.

HOW PIE TAX RULES AND THE TAX RATES FOR DIFFERENT TYPES OF INVESTMENTS ARE COMBINED

Type of investment	What is my expected tax?
Term deposits	Income x PIE tax rate.
Bonds	Income x PIE tax rate
New Zealand shares	Capital gains are exempt and most dividends are covered by tax the company has already paid (called imputation credits).
New Zealand listed property	Capital gains are exempt and most dividends are covered by tax the company has already paid (called imputation credits).
International shares	Tax calculated by taking 5% of the value of your international investments by your PIE tax rate.
Commodities	Tax calculated by taking 5% of the value of your international investments by your PIE tax rate.

These different tax treatments mean that the after-tax return from an investment can be quite different from the before-tax return. Comparing before-tax returns could result in an investor making the wrong investment decision. For example, let us assume that a bond, a New Zealand share and a global share all return 8.0% before tax. Does this mean they all return the same after taking into account tax? No.

An investor on a 21% PIE tax rate would receive 6.32% from the bond investment, 8% on the New Zealand share investment and 6.95% on the global share investment. It is these returns that an investor should be focusing on.

How might this change New Zealanders' investment decisions? As a nation, New Zealand has always enjoyed higher than average interest rates, which has historically made bank deposits an attractive investment. We have been further discouraged from investing in assets which grow over time because, until the new tax regime was introduced on 1 October 2007, almost all managed funds were taxed at 33%, even if investors in those funds were on personal tax rates of less than 33%! But most significantly, the new tax regime means that investors who play it safe (and therefore have a large allocation to cash and bank deposits) end up paying way more of their return in tax.

Over time, having to pay additional tax can lead to very different financial outcomes. Historically, there has been little financial incentive to weather the ups and downs that come with shares and listed property. Before taking tax into consideration, over the past 20 years, three-month term deposits have averaged 7.5% per annum. Over the same period, New Zealand shares have earned investors 7.2%pa, New Zealand listed property has earned 7.0% per annum. But, when the new tax regime is applied the numbers change significantly. After tax, returns from three-month term deposits would be only 5.9% per annum, whereas New Zealand shares and listed property would have returned 7.2% per annum and 7.0% per annum.

The latest¹ KiwiSaver statistics show that 82% of KiwiSavers are less than 55 years of age. Even a 55 year old KiwiSaver investor has a life expectancy, and therefore investment horizon, of between 20 to 30 years. Yet, surveys show that just over a third of KiwiSaver allocations are toward conservative default allocations that are predominantly invested in assets such as cash and bonds (which attract the highest tax rates). Many investors would benefit from reconsidering the mix of assets they are exposed to. Over a 20-year period, the difference between average term deposit returns (after tax) and average share market returns (after tax), for a 30% PIE tax investor, is almost a third more capital to enjoy in retirement. Death maybe inevitable, but paying a high level of tax on your investments and being miserable in retirement is not.

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