Questions and answers

New tax rules for people who save through qualifying collective investment vehicles

Q. Why is the government changing the tax rules for investment through managed funds?

A. The current tax rules on investment income operate very unevenly. They over-tax some investors, they favour direct investment by individuals over investment through funds, and they favour investment in some countries over others. They have a disproportionately negative effect on ordinary middle-income savers who invest via managed funds and are often over-taxed as a result.

The government is changing the rules to right the imbalance.

Q. How will the changes affect me as an individual investor in a qualifying vehicle?

A. Savers in qualifying vehicles will be taxed on investment income at their tax rate (capped at 33%). This means that people who have a 19.5% tax rate will be taxed on their savings at this rate, instead of 33% (which is the tax rate, at present, for most of those who invest in managed funds).

Savers will also benefit from not being taxed on capital gains made on New Zealand and Australian companies, if they invest in them through a qualifying vehicle. Currently, these gains are usually taxed if shares are held via a managed fund but are not generally taxed if held directly. This creates a significant disadvantage to using managed funds and other collective investment vehicles to invest in New Zealand and Australian companies.

Q. Do the new rules apply to all managed funds and investment vehicles?

A. No. The new rules are limited to managed funds and collective investment vehicles that meet certain criteria. To qualify, a vehicle must be a genuine savings and investment entity because the purpose of these changes is to put investment through intermediaries on a similar tax footing to that of direct investment. It is therefore important to distinguish genuine investment and savings vehicles from other entities.

The new rules will be optional, meaning that all savings vehicles do not have to adopt them. However, those that do will be able to offer their lower-income investors the benefits of being taxed at their correct tax rate, and the benefit of tax-free capital gains on shares in New Zealand and Australian companies to all their investors. Savings vehicles that do not adopt the new rules will continue to be taxed as they are at present.

Q. Why will the tax rate on investment income derived via a qualifying vehicle be capped at 33%?

A. The 33% cap is designed to encourage existing savers to continue to save and to encourage collective investment vehicles to adopt the new rules. Currently, investments in certain collective investment vehicles, such as superannuation funds, are taxed at a flat tax rate of 33%. This means that 39% tax rate investors are taxed at 33% on their investment income. Taxing them at 39% might discourage them from investing through intermediaries. Capping the tax rate on investment income earned through a qualifying vehicle at 33% should also make it easier for funds with a wide range of investors to adopt the new rules, without advantaging some and disadvantaging others.

Q. What will investors through qualifying vehicles have to do under the new rules?

A. Savers on a 19.5% tax rate should provide this rate at the start of the year to the qualifying vehicle. Other savers will generally not need to do anything. No individual savers will need to do anything else, such as file a tax return for any investment income from a qualifying vehicle.

Q. How do savers determine their correct tax rate?

A. Lower-income savers will be able to elect a 19.5% tax rate if their total income (including income from collective investment vehicles) in the previous year is $48,000 or less. Other savers will be taxed at 33%.

Q. Will the changes have any effect on savers' entitlements to family assistance or on their student loan and child support payment obligations?

A. No.

New tax rules for people who invest in offshore portfolio investment in shares

Q. Why do the offshore tax rules for portfolio investment in shares need to be changed?

A. There are a number of problems with the current tax rules for offshore portfolio investment in shares. Currently, individuals who invest directly in a company resident in one of the eight so-called "grey list" countries will generally pay tax only on dividends. On the other hand, if they invest in a "grey list" country via a New Zealand managed fund they will typically be taxed on any realised capital gains on these investments.

This tax treatment advantages direct investors over other savers, such as ordinary lower and middle-income people who use a managed fund and who may lack the wealth, financial sophistication, and confidence to invest offshore directly. The new rules will resolve the problem by requiring a reasonable level of tax to be paid by direct investors who have substantial share portfolios outside Australia. The current rules are also too harsh for investment outside the grey list, discouraging investment in other important destinations.

Q. What will be the tax impact of the rules on individual direct investors?

A. Under the new rules, investors in Australian-resident listed companies will generally pay tax only on their dividends (the same treatment that will be accorded to investors in qualifying collective investment vehicles). Investors will be able to have investments outside Australia that cost NZD$50,000 or less in total ($100,000 per couple) and continue to pay tax on dividends. For substantial share portfolios outside Australia, the "5% cap" method will generally apply. This will mean that in most years, taxable income is limited to 5% of the investment's value. (In most cases less than 2% of the value of the investment would be payable in tax.)

For substantial portfolios that are now heavily weighted towards the "grey list", individual direct investors are likely to pay more tax under the new rules. For investments in non-"grey list" countries, investors will pay significantly less tax than they do under the current foreign investment fund rules. This should encourage savers to look beyond New Zealand's traditional investment destinations to high-growth economies in Asia, Latin America and Europe.

Q. Why is a special case being made for investment in Australian companies?

A. There are three main reasons for treating investment in Australian-resident listed companies differently. First, Australian companies pay out a high proportion of their earnings as dividends. (Dividend distribution is encouraged by the Australian tax system.) Second, New Zealand has a closer economic relationship with Australia. Making a special case for Australia will help to move the two countries closer towards a single market for the purposes of investment and is therefore consistent with this relationship. Third, the New Zealand Inland Revenue Department has close contact with the Australian Tax Office and the Australian Treasury, which should allow the tax authorities to close down any tax loopholes that might arise. The proposed treatment for Australian companies reflects a simplification benefit – taxation on dividends – rather than a tax advantage.

Q. Will my compliance costs increase as a result of the new tax rules for offshore investments?

A. For most ordinary direct investors in offshore shares, the changes should not result in an increase in tax compliance costs. For example, an investor with some Australian shares and a portfolio costing NZD$50,000 or less outside Australia would continue to pay tax just on dividends. Investors with significant share portfolios outside Australia would face some extra compliance costs under the "5% cap" method. The additional costs will arise because investors will have to value their portfolio each year and keep track of carried forward amounts. It should be noted, however, that many will already use an accountant to assist with their tax obligations.

A. What is the 5% cap?

Q. The 5% cap is the main income calculation method that individuals will use under the new tax rules if they have a substantial portfolio in shares in companies outside Australasia. It will ensure that in most years the maximum income that tax will be paid on is 5% of the investment's value – it is not a 5% tax rate. In most years, the actual tax that is paid will be no more than 2% of the investment's value.

Q. Will any excess capital gains be taxed under the 5% cap method?

A. Yes. When the portfolio is sold and the proceeds brought back to New Zealand, 85% of the excess gains will be taxed. This treatment brings the taxation of direct investment income closer to that of income from investments in managed funds.

Q. Is this an offshore tax grab?

A. No. The government is giving up tax on Australian and non-grey list investments, and this broadly equals the increased tax on grey list investments outside Australia. The offshore tax changes are therefore roughly revenue neutral.

Q. Why is the government decreasing taxes onshore and increasing taxes offshore?

A. The government is not doing that. The new tax rules for offshore portfolio investment in shares raise no more revenue than the current rules. Onshore, the government collects tax on New Zealand companies under comprehensive company tax rules. The laws do not discourage payment of dividends meaning a reasonable dividend is usually paid. The proposed rules attempt to collect a reasonable level of tax offshore, as the government already does from onshore investments in New Zealand companies.