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This edition of Capital Eyes focuses on tax and the changes occurring at present to income tax rates and Prescribed Investor Rates. We also look at the difference between having PIE income and non PIE income under the new thresholds.

[The Bottom Line

Most people are interested in the end result, the “Bottom Line”, when it comes to investing - what they get “in the hand”, after tax and expenses. The rate of return is the main driver of the bottom line but the impact of the other two elements of return, expenses and tax, is also important. We want to focus on tax here but, first, a word about expenses.

It has been well proven by many researchers that using low-cost index funds is hard to beat. That’s why our portfolios mostly consist of “core” income and growth assets which have very wide diversification and very low costs. It is worthwhile investing in active/satellite/specialty funds if the managers can consistently outwit the core alternatives after allowing for expenses. If the return is still better after their fees have been paid or, if the addition of this investment improves the overall risk-return of the portfolio, then it stacks up. It is not always true to say that higher expenses produce lower returns. It may be quite the contrary. In short, it’s about the bottom line.



Tax also impacts the bottom line. Apart from the tax rates themselves, there are structures (companies, trusts etc) that affect the outcomes and there are different types of investments where the tax rules produce differing results. There are also combinations of structures, different investments and tax rules that alter the bottom line.

The Tax Working Group's (TWG) recent report contains a detailed exposé of all the quirks in our current tax system including some interesting observations and comment about structures and different investment vehicles. The report illustrates the use of Trusts and companies to return income above \$60,000 and provide benefits to individual taxpayers who gain the advantages of the lower rates applying above that level.

“ It is essential to remember that investment decisions should never be based on tax issues alone... ”

The report notes that Trustee income, taxed at 33% rather than a beneficiary's marginal rate of up to 38%, has been growing steadily since 2000 with an estimated loss in tax revenue of about \$300 million in 2007.

The TWG report makes some interesting comments about PIEs (Portfolio Investment Entities). All Kiwisaver funds are PIEs and there are lots of other PIEs as well. PIEs can provide opportunities for wide diversification, an essential element of any prudent investment strategy and they also offer some investors the opportunity to improve the bottom line – the after-tax result. It happens that PIE income does not affect the calculation for entitlement to some government benefits. The TWG report says “individuals investing in portfolio investment entities (PIEs) rather than a normal bank account” is an example “of behaviour to reduce tax or increase benefit entitlement.” Our reaction is that, whilst it might be OK to use a bank account for ready cash, it's not the right mechanism to invest for the long-term. Kiwisaver was designed for long term saving and the PIE environment was designed for it. It's unfortunate to see savings behaviour being criticised in this way though the anomalies in the system are there for all to see. The changes being made to tax rates for PIEs will remove some of the inconsistencies but others will remain.

One of the most interesting changes is the new PIR of 12.5% which applies if a taxpayer's income does not exceed \$14,000 of non PIE income and \$34,000 of PIE income (\$48,000 in total). \$14,000 is very close to the NZ Super level and it will certainly apply to most minors. If investors eligible to use the new rate of 12.5% use PIEs to invest they will be just under \$3,000 better off than “the bank” alternative.

Gross income (all sources)	48,000	
PIE income	34,000	0
Non PIE income	14,000	48,000
PIE tax @ 12.5%	4,250	0
Non PIE tax @ 12.5%	1,750	8,890
All tax	6,000	8,890
Bottom Line	42,000	39,110

People receiving NZ Super may qualify to use the 12.5% PIR if they have some expenses to off-set against their non-PIE income to bring it down under the \$14,000 threshold.

Similarly, at the thresholds for the next rate of PIE tax, investing using PIEs produces about the same amount of benefit. A person whose taxable income does not exceed \$70,000 is able to use a 21% PIR and have a \$3,000 benefit if they use PIEs.

Gross income (all sources)	70,000	
PIE income	22,000	0
Non PIE income	48,000	70,000
PIE tax @ 21%	4,620	0
Non PIE tax	8,890	16,150
All tax	13,510	16,150
Bottom Line	56,490	53,850

Important Note. These calculations assume the same rate of return for the PIE and non PIE investments. It is essential to remember that investment decisions should never be based on tax issues alone but all aspects of a strategy. Seek professional advice for all tax and investment matters.

The Tax Working Group report is a very interesting read. We are happy to email a PDF file on request. Please email to rose.drummond@capitalinvest.co.nz

Changes to RWT rates and PIRs

There are some changes we'd like to tell you about to Resident Withholding Tax (RWT) rates and Prescribed Investor Rates (PIRs) on PIEs that start on April 1st this year.

RWT

RWT rates on interest are changing to align with personal tax rates. Here are the details:

Old income amount	Old RWT rate	New income amount	New RWT rate
		\$0 - \$14,000	12.5%
\$0 - \$48,000	19.5%	\$14,001 - \$48,000	21%
\$48,001 - \$70,000	33%	\$48,001 - \$70,000	33%
\$70,001 and over	38%	\$70,001 and over	38%
Company rate	33%	Company rate	30%
No notification rate	38%	No notification rate	38%

If you are currently receiving interest which has RWT deducted at the rate of 19.5% you will be automatically moved to the new 21% rate from 1 April 2010. If you expect your annual taxable income to be \$14,000 or less, or over \$48,000 from April 2010 you may want to change your RWT rate.

You should only elect the 12.5% rate of RWT if you expect your taxable income for the year will be \$14,000 or less. If you earn over this amount you may end up with a tax bill.

If individuals or businesses fail to provide their IRD number and/or elect an RWT rate for new bank accounts opened from 1 April 2010 they'll have RWT deducted from the new account at the new no-notification rate of 38%.

If the IRD consider you are having RWT deducted at a rate which is inconsistent with your level of income, they may contact your interest payer and advise them to correct your rate.

PIRs

Prescribed Investor Rates (PIRs) apply to Portfolio Investment Entities (PIEs). PIEs were introduced in October 2007 when Kiwisaver started. PIEs provide some incentives

for investors compared to other types of investment vehicles. They currently offer lower tax rates for some investors, they calculate the tax based on the investor's PIR and pay the tax to the IRD at the end of the financial year.

There are some changes to PIRs and the thresholds where they apply. As mentioned above, from 1st April this year there will be a new PIR rate of 12.5% for NZ tax resident individual investors whose taxable income in either of the two immediately prior income tax years did not exceed both:

- \$14,000 (excluding PIE income); and
- \$48,000 (including PIE income).

The old 19.5% PIR moves to 21% for NZ tax resident individual investors who do not qualify for the 12.5% rate and whose taxable income in either of the two immediately prior income tax years did not exceed both:

- \$48,000 (excluding PIE income); and
- \$70,000 (including PIE income).

People who were on 19.5% before will move to 21% unless they have become eligible for the 12.5% rate.

There are some changes to the way PIE tax works for NZ tax resident trustees (excluding trustees of unit trusts). Where Trustees previously elected a PIR of 30%, income from PIEs was excluded from the tax return because it had been taxed at source. Where Trustees elected a 0% PIR the income, called "Non Excluded Income", had to be returned because it had not been taxed at source. In some instances, the 0% PIR caused problems where some beneficiaries became liable for provisional tax.

From 1st April 2010, NZ tax resident trustees (excluding trustees of unit trusts) may elect a PIR of 0%, 12.5% or 21% for the Non Excluded Income. If the Trustees elect a PIR of 30%, the PIE income is considered to be excluded income, taxed within the PIE as a final tax at 30%.

We will be writing to all clients about RWT and PIRs shortly.



New PIEs from Accordia Asset Management Limited

On November 20th 2009 Accordia Asset Management Limited's portfolios were launched. This was the culmination of a project that started earlier last year but had its beginnings more than three years ago.

The Accordia Portfolios are modelled using assets familiar to clients who have used the existing models. Our quarterly "Client Update" publications have provided information about the assets in the models. Now, The Accordia Portfolios use these. The portfolios are PIEs using "Underlying Pools" for the various groups of assets. The Underlying Pools are combined

in different proportions to suit varying requirements. The portfolios are subject to a thorough process of on-going review and monitoring.

We are very pleased to have The Accordia Portfolios to offer clients as investment vehicles. They provide the wide diversification and quality assets of the models but in a much "smoother", more flexible and user-friendly form. The PIEs will not suit all investors but, for most, they provide a further refinement in the process where Capital is always looking to provide the very best outcomes for its clients.



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For truly impartial advice about your investment needs, contact us to arrange a no-obligation consultation free of charge. One of our highly experienced and qualified investment advisers can help sort through the myriad of choices out there, so that you achieve your goals.



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