Taxation of Foreign Equities for New Zealand Residents

Executive summary of a white paper co-written with Kernel Wealth

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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 1.5% and 2% 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.

Typical tax drag from different investment vehicles
Percent per annum reduction in return

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

* 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

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*

Main 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 1.2% and 2.6% depending on how you invest. For Australian equities, the tax drag ranges from 0.8% to 2.3% 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.

- 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 0.50% (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 0.25% to around 0.6% 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 2.6% 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 1.5%. 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%.

- 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.

In summary, 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 – 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.

Not tax advice

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.

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