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Stobo Report on the taxation of investment income – A Review

1. Introduction

The Stobo report represents an opportunity to make some major improvements to the taxation of investment income in New Zealand, including the taxation of investment income for superannuation schemes. If implemented 10 years ago, these changes would have increased the annual return for a 33% tax payer on an average balanced fund from 6% to 7% per annum.

Despite some adverse public reaction, the proposals will lead to a reduction in the total tax payable, a positive move for investors.

2. Issues addressed

New Zealand has for some time thought highly of its tax neutral savings environment. In fact different rules apply to different situations - members of superannuation schemes know that the tax rules for their schemes have been highly unsatisfactory to both high rate and low rate taxpayers.

The objective of the review was "the minimisation of the extent to which the tax system distorts the way New Zealanders invest (direct versus via an intermediary or via different intermediaries)". The review was therefore expected to develop options for the taxation of onshore managed equity funds and all offshore equity investment whether direct or through a managed fund.

The issues of a capital gains tax or a tax favoured savings regime were outside the scope of the review, as was the taxation treatment of debt instruments, directly held NZ equity or property.

In essence the review therefore was looking at:

- the problem for managed funds of paying tax on capital gains, when an investor buying shares on their own account would not pay such tax,
- the attraction for investors of investing offshore in grey list countries and not paying any capital gains tax,
- the problem of investing in non grey list countries, with the consequent application of the Foreign Investment Fund (FIF) regime, and
- the application of the 33% tax rate for all investments in a superannuation scheme, irrespective of the investor's marginal tax rates.

The terms of reference were set by the Minister of Finance. Craig Stobo was assisted in his work by IRD and Treasury officials and the process involved wide consultation with industry participants. We note here that the report refers to all managed funds as collective investment vehicles (CIV's).

A copy of the Stobo report can be found at www.taxpolicy.ird.govt.nz.

3. Why address the issue?

Why is the matter so important? From an investors perspective, there is a desire to minimise their tax. But, as the report notes, from an economic health perspective for the New Zealand economy, it is important that tax is applied to changes in economic value and is not likely to distort the economy. The guiding principle of income tax policy is to tax an economic definition of income and Stobo quotes the most common definition of income as *"the change in market value of net assets plus consumption for a defined period."*

The consequences of the current policy include:

- IRD binding rulings granted to fund managers, so that index driven funds would not be liable to CGT. This has led to over investment in companies that are in these indices - there are estimated to be some $5.5 billion in passive funds,
- individually managed accounts (WRAP accounts) or blind trusts established by managed fund providers, which allow their clients to be taxed as individuals. The low charges for running these accounts are not available for the average investor, and

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- investors holding local shares directly and holding offshore shares (including offshore CIV's) in grey listed countries.

The current system works in favour of the current high net worth investor and against the interests of those who need to invest through managed funds (such as members of a company superannuation scheme).

The grey-list rules include the contradiction that a trust resident in a grey list country can invest in non grey-list companies thereby avoiding the FIF rules. As a consequence, 80% of New Zealanders' portfolio investment goes into or through grey list countries.

The report questions why there are different tax regimes for different types of CIV's when they are holding the same assets and notes that the taxation status of the investor should determine the tax the investor pays. The situation is not new – New Zealand has never harmonised the tax regimes for unit trusts, GIF's, life products and superannuation schemes.

4. Options considered

A key feature of the Stobo approach was the consideration of solutions that required questioning certain well-established conventions.

Taxation of income for onshore assets

The options considered were either elimination of the tax on capital gains or an Investment and Savings Tax (IST).

There are a number of different IST methods. In all instances they involve setting an assumed return on which an investor will pay tax (at their marginal tax rate) irrespective of the return achieved. The assumed rate could be set to reflect actual or inflation-adjusted bond yields, or simply be a rate chosen by the government.

Taxation of income for offshore assets

The options considered were an IST regime and the comparative value method, which is one of the existing calculation methods used for the FIF regime.

CIV and investor tax alignment

There is a choice involved, as either the CIV can settle the tax liability, or the tax liability can flow through to the investor.

Where the CIV is liable for settling the tax, the options are either for a proxy rate to apply for which the investor would receive a credit; or for the CIV to charge each individual investor at their marginal tax rate.

Where the tax liability flows through to the investor, again there are two options. Under the first option a resident withholding tax regime applies at a uniform rate, with a wash up later by the investor. The second option is similar to the current arrangement for bank deposits, where the investor supplies details of their tax rate to the CIV provider and tax is deducted at the rate advised.

5. The Stobo proposals

Stobo consulted widely on the options outlined above, to find that there was a consensus on the best options to proceed. The consensus view was to apply:

- an IST regime for offshore investments,
- CIV's with no capital gains tax for onshore investment, and
- withholding tax payments at the investors declared rate for CIV's.

Stobo agreed with the consensus, except for his preference for an IST regime for onshore investment, on the basis of complete symmetry between offshore and onshore investment.

The Minister of Finance has given the proposals his warm welcome, noting that a consensus for change now exists on some of the proposals and stating that the officials can now make real progress over a short period of time on what previously have been difficult issues.

The proposed date for implementation of the changes is April 2007.

6. Some illustrations

Impact of marginal tax rates

An investment offering a 10% before tax return results in a 6.7% after tax return for a 33% tax rate payer. However if tax payments were made at the investors declared rate, a 19.5% tax payer could expect an 8.1% return and a 39% tax payer could expect a 6.1% return.

Impact of capital gains tax removal

The impact of capital gains tax removal on an investment obviously depends on the relationship between the underlying income and capital return components. We have illustrated this below assuming that both NZ and overseas shares earn a total return of 10% gross and for a 33% tax rate payer.

As New Zealand shares pay high dividends, an expected 6.7% after tax return might increase to 8.4%. For overseas shares however there is less emphasis on dividends, so that an expected 6.7% after tax return might increase to 9.3%.

Consider the impact on a balanced fund return for the last 10 years which has achieved annual returns of 9.6% gross and 6.0% net of tax and fees. Eliminating capital gains tax on local shares, overseas shares and property increases the net annual return to 7.4% for a 33% tax payer.

Impact of IST on overseas shares

In the above calculations, once the impact of IST on overseas shares is allowed for, the net annual return reduces from 7.4% to 7.0% for a 33% tax rate payer.

7. Immediate issues

There are a number of immediate issues that need to be addressed.

- There will be a need for systems changes for fund managers and their managed funds. However the reaction to date is that the expenditure can be accepted, as the new tax system will have benefits to investors.
- The proposals are at a high overview level. Much of the detail has still to be worked through to allow them to be implemented
- There will be important transition issues in moving from the current to the new regime, not the least being how to deal with any deferred tax liabilities in a fund.

8. Issues for superannuation schemes

There will be a need to allocate income to members at their marginal tax rates and to accumulate the net amount in the scheme.

This will require tax to be allocated at the "right" rate and for there to be no additional tax payable by the member.

Defined benefit schemes are funded on an unallocated basis and therefore are not able to handle tax at an individual member level.

Defined contribution schemes have a similar problem with their reserve accounts being unallocated.

Lower rate taxpayers, who also receive State benefits, currently benefit from having a proxy tax basis with the tax on their investment incomes settled at the fund and not individual level. If they were to become liable themselves for tax on their investment income this increase in their overall incomes would effect their eligibility to the State benefits.

9. Issues for life insurers

There will be a need to allocate income to the savings components of each insurance contract. The 1997 Tolis proposals were not able to satisfactorily resolve this issue.

10. MJW comment

The proposals are attractive.

There will undoubtedly be cases made to defend current favourable positions and to find fault with some of the proposed changes. The idea of paying tax on a basis that takes no account of the return on the investment (IST regime) is new to NZ and is thus a very easy target for criticism.

The area of superannuation will be difficult to implement, with the issues raised by defined benefit schemes and reserve accounts in defined contribution schemes.

Yet overall the proposals do create a situation of lower tax payments for investors, particularly members of superannuation schemes.

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