Friday 19 April 2024

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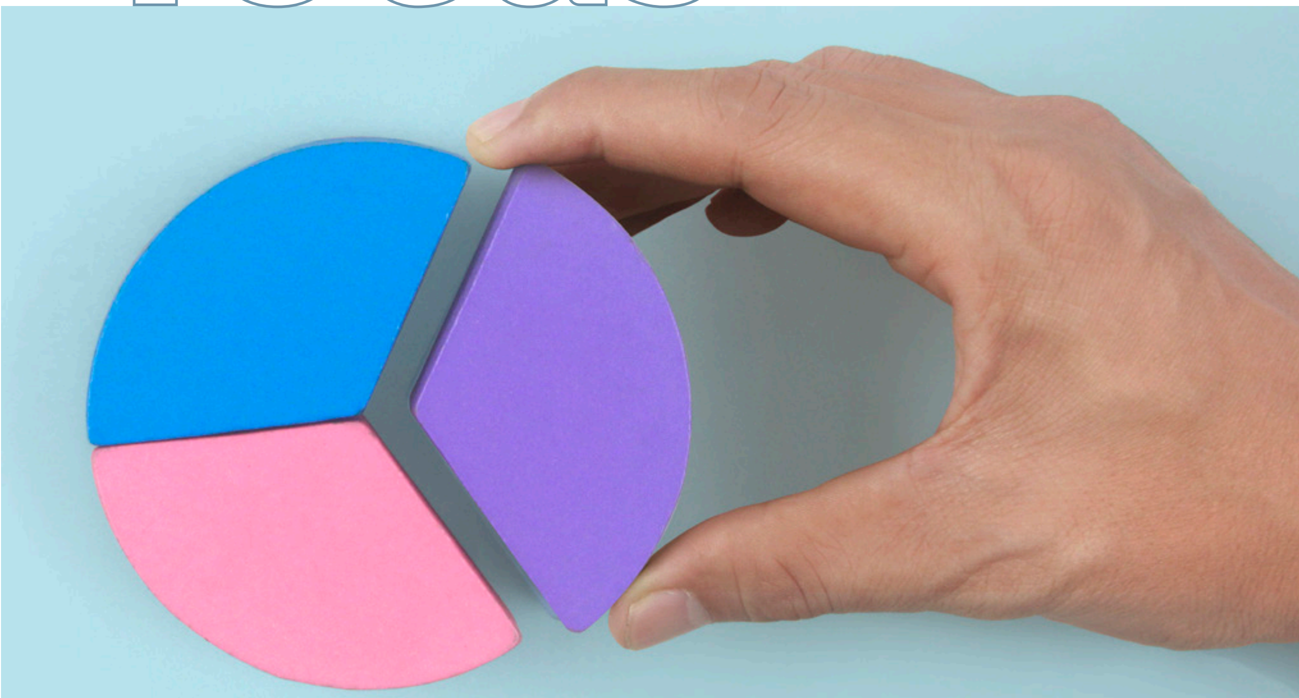

Responding to Trust Tax Changes: **Not as Easy as PIE**

Effective 1 April 2024 the tax rate for most trusts lifted from 33% to 39%, not an insignificant change. Understandably, many are now asking, should they change how they structure their investments? Also somewhat understandable is some of the advice circulating — shift to a PIE. In our view, however, this response is overly simple and ignores the raft of other factors you should consider when choosing your investments. Additionally, we suspect some overestimate the magnitude of the tax benefit from shifting to a PIE. The answer is, unfortunately, not as easy as PIE.

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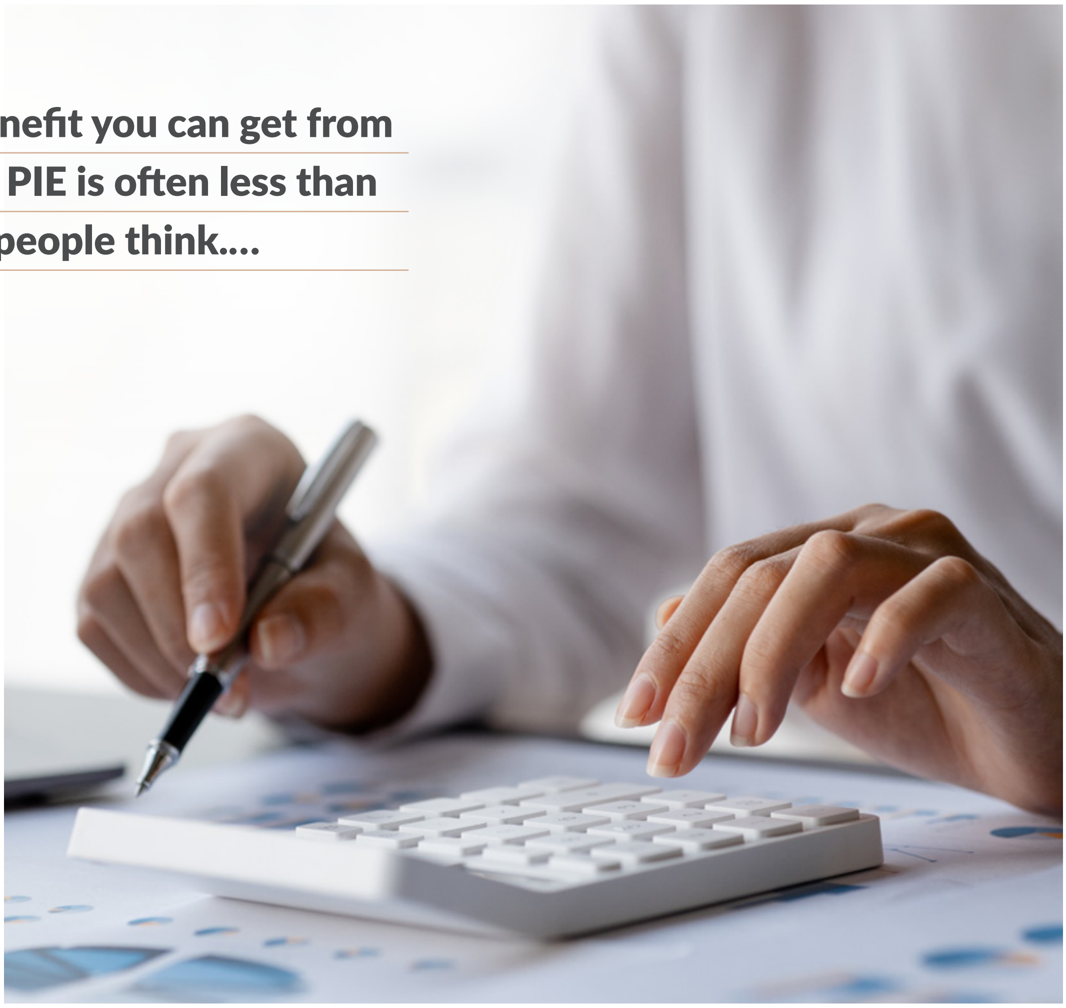

...the tax benefit you can get from moving to a PIE is often less than what some people think....

The benefit of a PIE

Portfolio Investment Entities (PIEs) were established in 2007 to encourage savings and investment. The principal advantage of a PIE is that the returns it generates are taxed at your Prescribed Investor Rate (PIR) which is capped at 28%. In contrast, investments outside of a PIE are taxed at your marginal income tax rate (up to 39%).

The benefit from a PIE may be smaller than you think

While reducing your tax is obviously appealing, in our experience, the tax benefit you can get from moving to a PIE is often less than what some people think. The saving also varies meaningfully across different types of investments.

Many investments in New Zealand are only taxed on the income earned, and not the capital gains. Therefore, the impact of a lower tax rate is more beneficial for investments that pay a higher income, such as term deposits or bonds. For investments, like many shares, through which the returns come more from capital gains the benefit is less. To put some numbers around this, indicatively we estimate the improved return (all else being equal) for a trust investing through a PIE compared to investing directly is currently around 0.6% to 0.7% per annum for a fixed income portfolio, around 0.6% to 0.65% p.a. for a portfolio of New Zealand stocks, and around 0.25% to 0.45% p.a. for a portfolio of Australian stocks.

When it comes to international stocks the picture gets a little more complicated. International investments are generally taxed under the Foreign Investment Fund (FIF) regime.

For these investments you can typically choose between using the fair dividend rate (FDR) or comparative value (CV) methods for determining taxable income. The FDR method calculates your taxable income on an assumed return of 5% of the opening value of your investments each tax year. The CV method calculates tax based on the actual return. In any given tax year investors can choose either FDR or CV for all their FIF-applicable investments. The FDR method is beneficial when the return is higher than 5%, while the CV method is optimal when the return is less than 5%.

There are, however, some exceptions to this methodology and one is for PIEs. A PIE investing in international stocks is always taxed using the FDR method. The consequence is that, in years when the investment returns are less than 5% a PIE's taxable income will be higher than if the investments were held directly or through an offshore-based fund. Based on our calculations this higher taxable income, on average over time, largely offsets a PIE's lower tax rate. Our estimate is there is less than 0.1% difference in the average returns between a trust investing in international stocks through a PIE compared to direct investment.

It's not only about tax

While tax is an important consideration when making investment decisions, it is only one of many things you should consider. The list of considerations is quite long, but specifically when thinking about PIE funds there are a few things we'd draw to your attention to: mix, choice, and fees.

Mix

Investment funds are a one-sized fits all solution. In contrast, direct investing allows flexibility around your portfolio.

Often the makeup of an investment fund is based on a share market index. In New Zealand, for example, many funds track or are benchmarked against the S&P/NZX 50. This is a very concentrated index with the top eight stocks making up almost 60% of the index's total investments. It's likely that if you invested in a New Zealand equities PIE you'd own all of these eight stocks whether you liked them or not. Similarly, the main Australian indices are dominated by financials and resources stocks. If you put money in an Australian equities PIE, chances are you'd always have a big exposure to Aussie banks and miners, irrespective of if you thought they were likely to be good investments.

In contrast, an investment portfolio can be tailored for your unique situation and preferences. What companies do you want to invest in? Are there sectors you'd rather not put your money in? Are you after higher or lower risk investments? Do you need income? There are many other personal factors that can influence what the right investment portfolio is for you.

Choice

While PIEs can be more tax efficient than alternatives, New Zealand isn't a huge market and, therefore, the choices around investment funds and other products is somewhat limited. Again, in contrast, global markets are huge with a vast range of available investment options. There are many good quality investment options outside of PIE funds that may benefit your portfolio.

Fees

While all investments typically incur fees, it's important to understand the nature and composition of fees you are paying. The tax benefit from using a PIE over other options such as direct investment or offshore-based funds can, at least in part, be offset by higher fees. PIEs can be more expensive than equivalent funds based offshore which benefit from greater scale. Funds can also have multiple layers of fees, including those you pay directly, plus potentially other costs that are incurred inside the fund.

> ...tax efficiency is only one of many factors...

Nothing wrong with a slice of PIE

Please don't interpret our message as being anti PIEs. We are not. We like the tax benefits PIEs provide, and use them for, or recommend them to, our clients when we believe they are high quality and best meet our clients' needs. Our message is that consideration of tax efficiency is only one of many factors that should be considered when selecting an investment. We suspect the advice that some are getting — "shift to a PIE" — may not consider everything required to reach a fully informed investment decision.

If you have any questions regarding your personal situation or if you wish to discuss what investment options might work best for you, please contact a Forsyth Barr adviser.

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