1. Savers in New Zealand managed funds

From 1 April 2007, New Zealanders investing in New Zealand-based managed funds and other collective investment vehicles will see greater fairness in the taxation of their investment income.

The new rules are aimed at removing a number of tax disadvantages for investors using managed funds, many of whom are ordinary, middle-income savers.

Benefits of the new tax rules for saving through collective investment vehicles

A key benefit of the new rules is that lower-income savers investing in vehicles that adopt the new rules will be taxed at their correct tax rate. Currently, lower-income savers are taxed at 33% on their savings even though their correct rate may be 19.5%. This creates a significant tax disincentive for lower-income savers to use managed funds in order to have access to a diversified range of investments.

The investment income of higher-income savers will continue to be taxed at 33%.

Another benefit is that capital gains on New Zealand and Australian shares held via a vehicle that adopts the new rules will no longer be taxed. Currently, these gains are generally taxed if held through a collective investment vehicle, even though these savers would generally not be taxed on capital gains if they held New Zealand and Australian shares directly. This has serious implications for investors who use managed funds to have access to a diversified range of investments.

What savers need to do under the new rules

Savers will need to know whether their collective investment vehicle has adopted the new rules, as the benefits outlined above arise only for investment via qualifying vehicles. Savers in qualifying vehicles will have to elect a tax rate and provide it to their fund at the start of a year. Their tax rate will be based on their total income for the previous year (salary and wages, interest and any other investment income).

There will be special rules for electing a tax rate. Savers whose total income in the previous year is $48,000 or less will need to elect a 19.5% tax rate. Other savers will be taxed at a 33% tax rate.

The qualifying vehicle will then pay tax on investment income, on behalf of the saver, at the saver’s tax rate. Investors will not generally need to report this investment income in their tax returns. This means that individuals who are not currently required to file a tax return will not have to file a return under the new rules. If a qualifying vehicle makes an investment loss, it will generally be available to savers without their having to file a tax return.

The tax paid by a qualifying vehicle on behalf of its investors will not affect savers' entitlements to family assistance such as *Working for Families*. This investment income will not be counted when working out entitlements, nor will it affect savers' student loan repayment and child support payment obligations.

Example – Difference in tax result under the new rules

Gary invests $20,000 in a defined contribution superannuation fund on 1 April 2007. His marginal tax rate is 19.5%. The fund actively invests Gary's money in a conservative portfolio with the following weightings: 50% in cash ($10,000), 35% in New Zealand and Australian-resident listed companies ($7,000), and 15% in companies resident in the United States, United Kingdom and Japan ($3,000). The investments have the following returns:

- Cash – interest of $500
- New Zealand and Australian shares – dividend of $350 (no imputation credits or credits for foreign non-resident withholding tax) and shares sold for $7,350 at year end
- Other offshore shares – no dividend and shares sold for $3,600 at year end
- Total return on assets – $1,800

His investment in a vehicle that does not adopt the new rules

If Gary's fund chooses to operate under the current tax rules instead of the new tax rules, Gary's return income would be taxable at a flat 33% rate and would include realised gains in New Zealand and Australian shares.

The fund would still be subject to the new offshore tax rules, so it elects to use the "85% comparative value" method.

Taxable income:
$500 (interest) + $350 (dividends on New Zealand and Australian shares) + $350 (realised gain on New Zealand and Australian shares) + $510 (85% of the gain on offshore shares) = $1,710

Tax liability: $1,710 x 33% = $564

<u>*Total net return:* $1,800 – $564 = $1,236</u>

His investment in a vehicle that adopts the new rules

If the fund adopted the new tax rules, the taxable income earned via the fund would be taxable at Gary's tax rate and he would receive the benefit of the New Zealand and Australian share gains exclusion.

Taxable income:
$500 (interest) + $350 (dividends on New Zealand and Australian shares) + $510 (85% of the gain on offshore shares) = $1,360

Tax liability: $1,360 x 19.5% = $265

<u>*Total net return:* $1,800 – $265 = $1,535</u>

Gary’s net return, in the example, has increased by nearly $300 under the new tax rules for collective investment vehicles.