Taxing Times

for "Trusted" Aussies

IT'S NOT A MATTER OF PRINCIPLE - nor is it a lost revenue issue. So why then is the government suddenly so interested in closing the tax loophole currently enjoyed by Australian Unit Trusts?


Hon Dr Michael Cullen, Deputy Prime Minister, Minister of Finance

The government's off-again, on-again approach to fixing its uneven revenue collection structure has made the tax loopholes enjoyed by some investment vehicles a 'smoking gun' for some time. At face value, the government's renewed focus on loopholes for tax-effective funds suggests a new tax regime might be just around the corner.

But fund managers and investors, all too familiar with government-speak on the subject, have every reason to be cynical. In fact, the departure of the tax-free status currently available to investment vehicles like Australian Unit Trusts (AUTs) has had more curtain calls than Jonah Lomu's All Black career.

Philosophically the government has never had a problem with tilted playing field when it comes to tax. In fact, various types of offshore funds have been offering tax efficiencies to Kiwi investors for many years. Nor does the tax the government is (supposedly) missing out on through AUTs - pose any real threat to its current fiscal position. It's true, AUTs could conceivably affect the government's fiscal position at some time in the future. But fund inflow into these investment vehicles would require a quantum leap for that to happen any time soon.

Cullen's bug-bear

So why has the government started a new hate-feast against AUTs?

What seemingly cheeses Finance Minister Michael Cullen off most about current tax laws is that it's possible for AUTs to invest in New Zealand stock, and not pay tax on it. But if the efforts of aggressive fund managers to put NZ assets into tax-efficient structures (like AUTs) really is red rag to Cullen – why hasn't he done anything about it before now?

"DEPARTURE OF THE TAX-FREE STATUS CURRENTLY AVAILABLE TO INVESTMENT VEHICLES LIKE AUSTRALIAN UNIT TRUSTS (AUTS) HAS HAD MORE CURTAIN CALLS THAN JONAH LOMU'S ALL BLACK CAREER."

Ironically, under existing tax laws someone can invest in NZ government bonds tax free via an AUT – while an identical investment through a NZ vehicle can't.

But if this is Cullen's main bug-bear, the argument remains somewhat academic. In practise, only a fraction of fund managers have adopted these practises. The fact that a few fund managers have established AUTs - with the express purpose of investing in local assets - shouldn't come as any surprise to Cullen. Especially considering it's the government that's responsible for creating an environment where this is possible. So that said, is the government looking to close down the tax loophole for all AUTs, just those investing in NZ government stock - or is it going to take a much wider view?

AUTs targeted

What's interesting about Cullen's most recent threats to remove loopholes for offshore funds is the unprecedented reference to AUTs. So if the threats laced within Cullen's recent speech to chartered accountants are to be taken seriously, tax loophole currently enjoyed by AUTs and possibly other tax effective funds - like UK-based Open-ended Investment Companies (OEICs) - do have a limited shelf life.

But while Cullen is big on rhetoric, he's given the market no specifics on how much revenue the government is missing out on, or how he plans to resolve the issue. It's hoped that the results of a soon-to-be released discussion paper will address the entire uneven tax collection structure. But even if the government finally means what it says, don't expect swift changes. Based on the tax advice some fund managers are getting, it could be 18 months before the government finally acts.

What tax loopholes?

So how does the exiting tax loophole for AUTs actually work? Since first launched onto the local market in 1986, AUTs have found huge favour with Kiwi investors. In fact, anecdotal evidence suggests they now have around $2 billion in funds under management. Interestingly enough, while the number of Australian-based fund managers applying for exemptions is shrinking, the number of AUTs being promoted directly to Kiwis (that meet local requirements) has been consistently growing.

Ironically, the tax status enjoyed by AUTs isn't really a loophole at all. To be more precise, the loophole is simply the interface between longstanding (NZ) law and that of other countries. Simply put, NZ investment vehicles are taxed as companies, while AUTs are taxed as trusts.

"UNLIKE REST OF THE WORLD, TAX ON LOCAL MANAGED FUNDS IS GATHERED INSIDE THE INVESTMENT VEHICLE BEFORE THE INVESTOR GETS THEIR RETURN."

Here's crudely how it works, AUTs and some other offshore funds (from countries with similar laws that the government respects) have a Securities Commission exemption from prospectus requirements. This exemption allows these funds to be promoted within this market without having to reinvent the wheel.

The tax-factor

That in itself isn't a big deal, but tax-factor is. These investment vehicles are taxed in a way that's unique to each country's domestic tax law. The big deal in all this is how offshore countries treat tax. Unlike rest of the world, tax on local managed funds is gathered inside the investment vehicle before the investor gets their return. Within offshore markets, tax is taken out at the individual level.

Considering the government has seemingly ignored consistent lobbying by the managed funds industry to simplify the collection of tax on investment vehicles, David schaardenburg general manager with FundSource says its current stance looks decidedly inconsistent.

"The evolution of AUTs has been driven off market forces created by the government tax regime. As they've grown, unit trusts have also evolved as a convenient tax collection vehicle for the government," says van Schaardenburg.

Big deal for investors?

So is the tax treatment on AUTs really a big deal for investors? The short answer is yes, and 'back of the envelope' numbers show exactly how much. Here's a simple calculation to illustrate the point. For every $10 invested in a local fund - the investor is left with $6.70 (after 33% tax is deducted). By comparison, the offshore fund would have around $9.15 (After allowing some notional tax leakage).

Compare the differential over time and you can see just how beneficial it is to have tax applied at the individual level - as opposed to having it taken out at source. Whatever stance the government chooses to take, van schaardenburg says it needs to understand that the interaction between NZ-based capital markets and those of the rest of the world is never going to go away.

He believes AUTs are just one means by which good fund mangers strive to deliver on commitments to their unitholders. He suspects the managed fund industry's gravitation towards AUTs is in part, a patch-protecting exercise, necessary to compete with many of the industry's more aggressive operators. "The reason why fund managers exit at all is to deliver the best risk-adjusted returns for their clients – once tax and deductions have been taken out," says van schaardenburg.

Call to action?

So where does the government's call to review its tax collection structure leave existing AUT unitholders or those contemplating buying similar tax-effective funds? There's no real call to action, says Richard Baker general manager with Tower Managed Funds, so long as investors are comfortable with the funds they've entered. Up until now, he says some AUTs have been cleverly constructed to sit within the boundary of existing regulations - to distribute income and get over circulatory issues by investing offshore.

But with or without loopholes, he doubts AUTs will be significantly affected. In fact, Baker believes investors would be better served focusing on the current law rather than what may or may not happen in the future. Like Baker, Kevin Podmore managing director with St Laurence Ltd doesn't believe the underlying argument for entering AUTs (or any fund) will really change if investors are properly matching funds to their own investment requirements.

"ONE OPTION THAT MOST FUND MANAGERS COULD LIVE WITH IS THE RISK-FREE RATE OF RETURN REGIME - LIKE THE ONE PROPOSED LAST YEAR BY THE GOVERNMENT'S MCLEOD TAX COMMITTEE."

Window of opportunity

It's true, how fund managers treat tax issues can have an important impact on their ability to maximise investor returns. But that said, Podmore argues that tax benefits should play second fiddle to the fund manager's track record, quality of assets, and whether their investment strategy complements an investor's long tem goals.

Only then, he adds can investors ask - what's the best structure for these investments? Fund managers have always been good at adapting to law changes, and he's suspects they will be equally deft at capitalising on any future distortions, whatever they may be. "Meantime, there's a window of opportunity for investors to take advantage of AUTs for least another 18 months," says Podmore.

Whether the government opts for a "patch-up" solution - by just targeting AUTs investing in government stock - or addresses other inconsistencies within the exiting tax regime, remains to be seen.

But Simon Botherway of Brook Asset Management says it's important the government neither perpetuates the unfair tax treatment - that's forcing local fund managers' offshore - nor creates new tax anomalies in its attempts to remove those that currently exist. "It's no secret, huge distortions within the tax system go well beyond AUTs. It also raises questions about what's passive and active, and whether TET is more appropriate than a TTE regime," says Botherway. "For example, it's currently possible to invest in active UK-based OEICs and pay no capital gains tax."

Risk-free return

So are there any clues as to what type of tax regime we're heading for? One option that most fund managers could live with is the risk-free rate of return regime - like the one proposed last year by the government's McLeod tax committee. Under this option the government would dictate what an imputed return will be. Assuming the imputed return is set against government stock rates, Baker says the onus will be on investors to seek out quality absolute return fund managers. In other words, if the government stock rate is 4% and a fund delivers 12% absolute returns – then 8% is effectively tax free.

No free lunch

But what will and won't be taxed is something many mum and dad investors struggle with, says John Shewan tax partner with PricewaterhouseCoopers. Adding to that confusion is the structure under which some investment vehicles operate. What many investors simply don't realise, adds Shewan is that if they buy units offering no realistic dividend yield, albeit distributions in the form of tax-free bonus units - trying to explain that selling isn't the end-game will be ambitious.

What the language coming out of Cullen's camp tends to suggest, says Shewan is that if you go out to buy a dog, don't be too surprised when it starts barking. In other words, if retail investors thought they could avoid being taxed on gains simply by holding them in their own name, they'd be dead wrong. Assuming selling is the end-game - the gains will be fair game for tax.