

PIEs – Practical impact for investors and recent developments

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Over the past year there has been much written about the Portfolio Investment Entity (PIE) rules from a technical perspective. In this article we step back to look at both the practical impact of the PIE rules for individual investors in terms of effective rates of return and some of the interesting market developments in relation to PIEs.

Impact for individual investors

The following table illustrates the additional gains that New Zealand investors with marginal tax rates of 39% and 33% can achieve when investing in PIE products compared to non-PIE products.

An investment in a PIE of NZ\$10,000 is assumed. The PIE is a Portfolio Tax Rate Entity (the most common form of PIE). For comparative purposes, a base case of \$10,000 placed in a non-PIE investment (such as a fixed rate bond) returning 9% p.a. interest is used. The table assumes that a Prescribed Investor Rate (PIR) of 30% (the maximum PIR from 1 April 2008) has been selected.

Investment type	Interest % return	Marginal rate	PIR	Interest	Tax	Post-tax return
Non-PIE	9%	39%	n/a	\$900	\$351	\$549
PIE	9%	39%	30%	\$900	\$270	\$630

Non-PIE	9%	33%	n/a	\$900	\$297	\$603
PIE	9%	33%	30%	\$900	\$270	\$630

The effective return received on the PIE investment is as follows:

- 10.33% (at a 39% tax rate); and
- 9.4% (at a 33% tax rate).

The concept of “effective return” refers to the greater pre-tax return that would be required from a non-PIE product to result in a similar after tax cash position to that earned from an investment in a PIE.

Taking the 39% marginal tax rate payer first, these calculations demonstrate that the after tax cash position for these investors is increased by \$81. When compared to the base case non-PIE product, the effective return achieved is therefore 10.33% - an almost 15% increase in the investor's after tax cash position. An investor on a 33% marginal tax rate gains a more modest \$27 after tax by investing through the PIE product (a 3.8% increase in the investor's after tax cash position).

As illustrated above, the introduction of the lower corporate tax rate and maximum PIR of 30% created a benefit for those paying tax at 33% through investing in PIEs. Those investors were previously “PIE-

neutral” in tax terms. The drop in the corporate rate also further improved the position for investors paying 39% marginal tax.

An additional benefit may accrue for a PIE investment through the timing of PIE tax liabilities. This benefit may arise due to the later payment of tax for a PIE, particularly where an election has been made to pay tax annually, when compared to the resident withholding tax deductions required at the time interest or dividends are paid on a non-PIE product.

Investing through a trust

The trustee of a family trust can elect a PIR of 30% or 0%. If a 0% rate is selected, the income from the PIE will be taxed under the existing trust tax rules. Which PIR is chosen by the trustees of a trust will depend in large part on whether the income is intended to be retained by the trustee or distributed to the beneficiaries, and the marginal tax rates of the trust’s beneficiaries (if it is to be distributed).

In summary, income which is derived by a trustee in any income year and which is not distributed to a beneficiary of the trust during or within six months after the end of that income year is “trustee income”. The trustee will be liable to tax at the 33% trustee tax rate. Where trust income is distributed during or within six months of the end of the income year in which the income was derived, that income will be “beneficiary income”.

The 30% PIR is a final tax, meaning that no further tax will be payable on income derived from a PIE. Therefore, a trust should elect this 30% rate if the income would otherwise be taxed as trustee income or the income is intended to be distributed to beneficiaries within six months of year end who are liable to pay tax at either 33% or 39%. If a 30% PIR is selected, the PIE income derived by these parties will be excluded income and will not need to be included in either the trust’s or the beneficiary’s tax returns.

However, the 30% PIR is disadvantageous for a beneficiary who would otherwise pay tax at 19.5%. Any tax paid at the PIE level which exceeds a taxpayer’s personal tax liability will not be refundable to a 19.5% rate beneficiary. Therefore, where a trust has beneficiaries on 19.5% rate and the trustee wishes to distribute PIE returns as beneficiary income, the trustee would elect a 0% PIR.

Other benefits of PIE investment

Aside from the tax rate benefit of investing in PIE products, there may be other potential benefits for investors, including the following:

- Natural person investors and trustees (other than of a unit trust) are not required to file a return of income in respect of exempt PIE income; and
- PIE income will not generally affect:
 - An investor’s ability to claim Working for Families tax credits; or
 - Student loan and child support obligations.

Emerging PIE products

Cash PIEs

One of the more interesting products to emerge as a result of the PIE regime is the “cash PIE”. A number of these products are currently available. From our review, the key features of a typical cash PIE are:

- The fund is a unit trust that is a portfolio tax rate entity (the most common form of PIE entity);
- The fund invests solely in NZ dollar denominated call deposits with the offering bank or financial institution;
- The unit price on purchase is the value of the fund from time to time, divided by the number of units on issue;
- Distributions are made by way of the periodical issue of new units. Typically, no cash distributions are made to investors; and
- Investors can redeem units as frequently as desired in order to withdraw all or part of their investment. Generally, no withdrawal fees are charged.

These funds are very liquid, so they perform in the same way as a regular non-PIE call account but offer the benefits of PIE taxation. Deposits and withdrawals are processed by way of unit subscriptions and redemptions.

As outlined above, due to the lower PIE tax rate and exempt distributions enjoyed by 39% and 33% taxpayers, the “effective return” on a cash PIE product will be greater than the return from a non-PIE cash product paying the same base rate of interest.

It is worth noting that the base rate of return (ie the effective interest rate) offered by cash PIEs is generally lower than a comparable non-PIE cash deposit rate. Although the investor is better off overall, it appears that most offerors take a “slice of the pie”, sharing in the investor’s tax benefit.

Portfolio Listed Companies

Investors were recently invited to purchase perpetual, non-cumulative shares in a newly formed portfolio listed company (PLC) under the management of one of New Zealand’s major trading banks. As far as we are aware, this was the first public offering of its kind since the inception of the PIE regime. The shares were offered to New Zealand resident investors and are now trading on the NZDX (the debt market of the New Zealand stock exchange). The issue was assigned an A+ credit rating by Standard & Pools.

The PIE tax benefits of a PLC are significant. These include the tax exemption on gains from disposals of New Zealand and Australian listed shares (and certain unit trust interests) as well as the advantage of reduced marginal taxation as described above.

If an investor wishes to withdraw their capital, funds can be realised by selling shares on the secondary market.

Investors in a PLC do not notify the company of their relevant PIRs. Instead, a PLC is taxed at the corporate tax rate and must fully impute any dividends to the extent that imputation credits are available. However, to the extent that a dividend is not fully imputed, that amount is exempt income in the hands of investors.

Although imputed dividends are also exempt, an investor may elect to include the dividend in its annual return. For example, an investor on the 19.5% marginal tax rate might elect to include the PLC dividends in its return of income to allow excess imputation credits to be offset against other taxable income.