pensionbriefing

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If I won $5 million: structuring investments to maximise after-tax income

RPRC *PensionBriefing* 2009-4

To illustrate the growth of complexity and resulting inequities in the current tax environment, this *PensionBriefing* outlines the way in which investments may be structured to maximise their after-tax returns. In order to describe the issues involved, the *PensionBriefing* takes a hypothetical case of winning $5 million.

Not many people win a large amount of money on Lotto – that's why the top prize can be so large. However, selling a business or receiving an inheritance could see a relatively large amount of capital available for retirement income. We examine the use of 'portfolio investment entities' and registered superannuation schemes, including the case where New Zealand Superannuation is payable.

This *PensionBriefing* is a companion piece to *PensionBriefing 2009-3* - *Structuring remuneration to maximise value through salary sacrifice*. That showed how a hypothetical employee on a pre-tax remuneration of $150,000 a year could, with a cooperative employer, use current rules to increase after-tax remuneration by $6,125 a year.

Here we look at using current rules to increase the after-tax value of investment income using different vehicles. The main point of these two *PensionBriefings* is not to offer tax, investment or remuneration advice but to point out:

- the complexities of New Zealand's current income tax environment;
- how far New Zealand has moved from a comprehensive definition of 'income'.

Assumptions

This *PensionBriefing* assumes that an individual invests $5 million at a pre-tax interest rate of 5% per annum, the equivalent of a conservative estimate of a return from a cash-based investment. The gross annual income is therefore $250,000. It also assumes the individual (and, where relevant, the individual's partner) has no other taxable income.

Investing directly

If the individual had no other taxable income, the after-tax income from the $5 million is shown in Table 1:

Table 1

Individual investing directly	
Before-tax	$250,000
Tax	$84,550
Net after-tax	$165,450
Net as % of gross	66.2%

Note: the income tax bands and rates current at the date of this *PensionBriefing* are explained in the Appendix.

If the individual were one of a couple, a relatively simple step (**Step 1**) would be to split the money evenly to maximise the advantage of the lower income tax bands. That can be done through an agreement under the Property Relationships Act with no gift duty implications and with immediate effect (no gifting programme needed). After the split, Table 2 shows the combined position:

Table 2

Couple investing directly			
	Partner 1	**Partner 2**	**Total**
Before-tax	$125,000	$125,000	$250,000
Tax	$37,050	$37,050	$74,100
Net after-tax	$87,950	$87,950	$175,900
Net as % of gross	70.4%	70.4%	70.4%

This Step 1 would save the couple $10,450 a year in tax.

For the rest of this *PensionBriefing*, the calculations will stay with the couple as that best illustrates the advantages of restructuring ownership of the investment asset.

Step 2 - Using a PIE and a 'registered superannuation scheme'

A 'portfolio investment entity' (PIE) is a tax-efficient investment vehicle. That means the investors will pay less tax investing in exactly the same asset ('cash' in this example), as the couple would have done owning the investment directly. The rules that apply to PIEs are complex and are summarised in the Appendix.

The lower tax rate that applies to PIE income is presently 19.5%. As this is more than the lowest personal rate (12.5% on income to $14,000 a year), it makes tax sense for each of the couple to earn at least $14,000 a year directly. On the assumptions, each of the couple should keep $280,000 in their own names: 5% on $280,000 is $14,000.

Then, in the present case, after the spilt (Step 1), each of the couple should contribute sufficient to a PIE so that the pre-tax PIE income is no more than $46,000 a year. That means the total of the direct investment income and the PIE income is no more than $60,000 a year. Using an investment return of 5% a year, each Partner will contribute $920,000 to the PIE and, on the assumptions, the tax rate that applies to the PIE-derived income will be 19.5%.

Had all the money been contributed to the PIE, tax of 30% would have been payable on all the income generated by the PIE.

Instead, the rest of the money ($1.3 million) should be contributed to a registered superannuation scheme that is not a PIE. The tax payable on this income will also be at 30%. The income earned in that scheme is not included in the Partners' own tax returns; nor does it count in the calculation of the PIE tax return[1]. The superannuation scheme is a 'final' taxpayer.

Table 3 on the next page shows the new position for the couple.

[1] It also does not count when entitlements are assessed for Working for Families' payments; the new Independent Earner Tax Credit; nor for student allowances, child support and maintenance payments to a former partner.

Table 3

Couple investing directly and using a PIE and superannuation scheme			
	Partner 1	**Partner 2**	**Total**
(a) Directly			
Before-tax	$14,000	$14,000	$28,000
Tax	$1,750	$1,750	$3,500
Net after-tax	$12,250	$12,250	$24,500
(b) PIE			
Before tax	$46,000	$46,000	$92,000
Tax	$8,970	$8,970	$17,940
Net after tax	$37,030	$37,030	$74,060
(c) Super scheme			
Before tax	$65,000	$65,000	$130,000
Tax	$19,500	$19,500	$39,000
Net after tax	$45,500	$45,500	$90,000
Totals			
Tax	$30,220	$30,220	$60,440
Net income	$94,780	$94,780	$189,560
Net as % of gross	75.8%	75.8%	75.8%

This Step 2 would save the couple income tax of:

- $24,110 a year over the amount that the 'single' investor would pay if all the investment income were earned directly;
- $13,660 a year over the amount the couple would pay after splitting the investments (Step 1).

When the older partner reaches age 65

This *PensionBriefing* has assumed so far that the individuals have no other taxable income. That changes when the older partner reaches age 65 and starts receiving New Zealand Superannuation (NZS). NZS is taxable income received by each in their own right and cannot be assigned.

(a) Partner 1: The arrangement in Table 3 will now need to change because Partner 1 will receive NZS of, currently, $14,229 a year before tax. This is almost the same as the first tax band at 12.5% covers (up to $14,000 of taxable income) so Partner 1 should now make a further contribution of the $280,000 investment directly held to the registered superannuation scheme (not the PIE).

A small amount ($4,580) should also be shifted from the PIE to the superannuation scheme to ensure that the total of NZS and the PIE income does not exceed $60,000 a year. This will leave $915,420 in the PIE ($920,000 - $4,580) providing, on the assumptions, income of $45,771 a year before tax.

There will now be a total of $1,584,580 in the registered superannuation scheme for Partner 1 providing before tax income of $79,229 ($55,460 after tax at 30%).

(b) Partner 2: There is another consideration that may now apply with respect to Partner 2. NZS can be payable to a person before reaching age 65 but that is subject to an income test. Under the current rules, income earned through a PIE or a registered superannuation scheme is not 'income' for this purpose. As long

as the couple's before-tax income is less than $4,160 a year ($80 a week), the younger partner in the example can also receive NZS. On that basis, Partner 2 should also re-arrange the investments in the same way as Partner 1 so leaving the couple with no directly taxed investment income. There would not be any point in having the $4,160 concession available before the income test bites. That's because the $4,160 would be taxable at 21% which is more than the PIE's 19.5%. However, depending on the couple's spending needs and other realisable assets, draw-downs by either Partner from the arrangements described above may be deemed to be 'income' for this purpose – see paragraph (e) on page 5 for more on this.

Partner 2 should maintain those arrangements after reaching age 65 and becoming directly entitled to NZS.

Investment return

This *PensionBriefing* has used a 5% p.a. return as an example. In practice, the returns in each of the investments will be driven by the Partners' chosen investment strategy (and the markets). Given the tax significance of keeping the combined total of direct investment income and PIE income below $60,000 each in at least one of the last two financial years, the total will need to be monitored. The test is an 'all or nothing' one: if the total exceeds $60,000 in both of the preceding tax years by only one dollar, then all the PIE income will be taxed at 30% (the same rate as in the registered superannuation scheme). Money might need to be shifted from the PIE to the registered superannuation scheme to avoid that.

On the other hand, because the test is based over two years, if the Partners each qualify this year, it doesn't matter what they earn next year (and its mix between direct and PIE income) as long as they each re-qualify in the following year.

In the example used in Table 3, the penalty for breaching the $60,000 total would be extra tax of $4,830 for each Partner ($13,800-$8,970).

Superannuation as a planning tool

This *PensionBriefing* illustrates how the new tax rules may be used for planning purposes. Using a PIE and a registered superannuation scheme may offer individuals advantages over more traditional financial planning tools such as family trusts for the following reasons:

(a) Low cost: The above arrangements do not require the Partners to establish complex family trusts or corporate entities[2]. The couple can use publicly subscribed vehicles offered by most financial service providers. There will be investment management fees and perhaps also some relatively small membership fees but most of those would also be payable if individuals established their own arrangements and used professional investment managers.

If the couple had particular investment requirements, the registered superannuation scheme could be a vehicle established specifically for the couple. However, that would involve regulatory compliance (investment statement, annual audited accounts, annual return to the Government Actuary etc).

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[2] There may be other reasons for establishing those vehicles such as the protection of infant beneficiaries, creditor protection or protection against potential property relationship claims.

It would not be possible for the couple to have their own PIE because the ownership concentration rule for a PIE requires at least 20 'unassociated' members and each holding comprising no more than 20% of the voting rights in the underlying investment.

(b) **Immediate effect:** Because each of the suggested transactions involves a contribution to a scheme in the member's name, there would be no question of gift duty and so no gifting programme as is usually needed in the case of a family trust.

(c) **Ownership:** The money in each case belongs indirectly to the two individuals. That means there is no loss of control; nor is there any need for consideration of the needs of other potential beneficiaries as can happen with a family trust. It also means that, on death, the money can form part of the member's estate or, depending on the scheme's rules, could be passed directly to nominated beneficiaries.

(d) **Flexible:** Each of the steps suggested can be unwound if tax or other rules change (as they may). The Partners should be careful to ensure the PIE and registered superannuation scheme allow them immediate access to withdrawals to that end. There are schemes that allow that.

(e) **Living expenses:** Part of the point of the suggested structure is to provide the couple with retirement income. They should use the money in the registered superannuation scheme for this purpose, not the PIE. The couple can establish a regular monthly drawdown with some superannuation providers and would need to ensure that was possible before making contributions. Being also able to withdraw *irregular* amounts would be an advantage. Amounts received in this way are not taxable but will be received as capital. They will therefore not affect the tax status of the arrangements described.

If Partner 2 is to receive NZS before age 65, the regular drawdown by either Partner to meet living expenses may be deemed to be 'income' for the income test, even though, for tax purposes, it is actually after-tax capital. Work and Income NZ has considerable discretion as to what counts as 'income' for this purpose. If the arrangement were intended to apply for a relatively short period, it might be possible for the couple to use some form of non income-earning but accessible asset to help meet living expenses until Partner 2 reached age 65.

(f) **Salary payments:** If either Partner has an income earned from employment, that can be 'salary sacrificed' in full to the registered superannuation scheme (not the PIE) without affecting the tax arrangements described above. If the employer is using the variable 'employer superannuation contribution tax' (ESCT) rates, the tax deducted from the sacrificed amounts would be 12.5%, 21% and 33% depending on the amounts involved[3]. This will effectively allow the Partner concerned to have a double tranche of income taxed at only 12.5%. This is because the variable ESCT rate is based on the income (before salary sacrifice) derived just from that employer and not on the employee's total taxable income from all sources.

[3] See *PensionBriefing 02/2009* here for more on the 'salary sacrifice' rules.

Comment

This *PensionBriefing* illustrates the now complex interaction between the 'income' earned directly and through vehicles that are taxed as a proxy for the members involved. It also illustrates the impact of definitions of 'income' on potential entitlements to income-tested welfare payments.

The point of analysis is not to recommend that any individual investor re-structures their investment in this way; rather, it is to highlight the need for an urgent review of policy in this area before such techniques are widely adopted. In principle, it is difficult to support an environment where the total tax payable by the couple depends not on the returns earned by the underlying investments (in the example, cash) but rather on the way they structure their holdings. It may be even less supportable for welfare payments by the state to be also directly affected by that structure.

A return to a more comprehensive definition of 'income' would make the environment simpler and less prone to re-arrangement simply for tax and welfare gains.

For comments on this briefing and further information please contact:

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Appendix – tax definitions of 'income'

(a) 'Earnings' for income tax

The 'income' for ordinary income tax is, in the present case, investment income directly received. Tax to be paid accumulates by income band as follows:

Taxable earnings	% tax on this band
0 to $14,000	12.5%
$14,001 to $48,000	21%
$48,001 to $70,000	33%
$70,001 and over	38%

Note: Details are as at 1 April 2009.

(b) For PIE income

The tax payable by a PIE in respect of a member depends on the amount of the total in a financial year (ending on a 31 March) of:

(i) the member's taxable earnings;

(ii) other taxable income received by the member (interest, dividends, other employment);

(iii) PIE income in that year.

We'll call the total amount calculated in this way for the year the "**PIE Total**".

The member must advise the PIE whether the PIE tax rate (what the Act calls the "Prescribed Investor Rate" or PIR) should be either 19.5% or 30% as follows:

PIE Total	PIE tax rate
0 to $60,000	19.5%
$60,001 and over	30.0%

Notes:

1. The PIE tax rate is an 'all or nothing' test. If either the **PIE Total** exceeds $60,000 or the total of the member's directly received taxable income exceeds $38,000 in that year, the PIE tax rate must be 30%. Both the **PIE Total** and the other directly taxable earnings must meet the appropriate test for the lower 19.5% rate to apply. If either is exceeded, the 30% rate applies to the PIE income.
2. The **PIE Total** includes "portfolio investor allocated income" from all PIEs but does not include income from collective investment vehicles that are not PIEs but that are "final" taxpayers, such as another registered superannuation scheme or under an unregistered "superannuation scheme", as defined in the Income Tax Act 2004.

The 'year' to which these tests apply is not straightforward – it applies only to complete financial years and if the test is satisfied in either of the last two financial years, the lower PIE tax rate applies in the current year, regardless of either PIE income or taxable income in either the other of the two years or the current year.

The PIE must comply with the member's election as to the PIE tax rate.[4]

[4] The government has announced (7 July 2009) that the marginal tax rates that apply to personal income will also, in some way, be also aligned to the PIE's "prescribed investor rate" or PIR. There were no details as to how this might be implemented.