Newsletter: Winter 2006

STUART + CARLYON

Financial advisers for your lifetime goals

A taxing time - Peter Dunne cooks up a very lumpy tax porridge.

Finally we have seen the proposed tax changes and can only confirm that they certainly won't go down as Minister of Revenue Peter Dunne's finest hour in Parliament. It will have been hard to miss the adverse press comment on this inconsistent new Tax Bill because it singles out overseas investments for a tax on unrealised capital gains. This is like taxing workers before they've earned their wages. It also seeks to play favourites within the investment market – a strategy we haven't seen, really, since the Muldoon days.

The Bill is now at select committee stage in Parliament. There will be many submissions and hopefully some positive changes before we know its final form by the end of this year.

> "...the proposed regulations are complex and will generate tons of work for tax accountants..."

What does it mean for our clients?

- All overseas investments (except bank accounts, Australian shares and some foreign super schemes) will be taxed on dividends plus 85% of the unrealised capital gains each year. Currently tax is due only on the dividends for Grey List countries.

Among others this means US and UK shares, UK listed trusts and Australian unit trusts will now be caught in the foreign investment fund regime.

- The starting point for individuals is your choice of original cost value or the market value on 1 April 2007.
- Although 85% of the overall gain is taxable, the amount of tax you need to pay each year is capped at a return of 5%, or the cash dividend if that is higher. This helps smooth out the tax paid annually.
- Excess taxable gains are carried forward and brought to account when shares are sold.
- However, if shares are sold but reinvested in other overseas funds the tax remains deferred ie: if you keep the money offshore in similar investments, accrued CGT is not due.
- Carried forward gains disappear on death for individuals.

As you can see, the proposed regulations are complex and will generate tons of work for tax accountants as investors keep a running tally of their tax-owing, year by year.

Concessions signal Government's own qualms

The Government has already been forced to make a number of concessions in an attempt to make the overseas tax more palatable. Because the accrued liability disappears at death, an individual may never actually pay the full amount of tax - if they can afford to keep money invested offshore. And GPG shareholders are being given a 5 year exemption. Such concessions make it questionable as to why the tax is even being introduced.

A further concession reveals the Government's own qualms.

- Individuals holding less than $50,000 worth of overseas shares, will be exempt from the capital gains tax ($100,000 for a couple).

This remains inconsistent however. Many of our clients own assets via a Family Trust and for these people there are fewer concessions:

- The market value of your total overseas share portfolio on 1 April 2007 will be the start value, even if the cost value was higher.
- There is no $50,000 exemption for Trusts.

Playing favourites or distorting the market?

There are other changes in the Bill that will affect tax rates for NZ unit trusts and super schemes. The aim is to make the new KiwiSaver scheme more attractive. However, the costs to fund managers and IRD in changing their admin systems is likely to be huge and it's hard to see the benefits outweighing the costs.

Sooner or later, any move by a Government to cause distortion in the investment market will cause problems for investors.

We believe there must be a fairer and simpler alternative and that will be the basis of our own submission. To make New Zealanders more prosperous, the Government needs to be encouraging savings and investment both overseas and locally. Instead they are making it so complex that investors will be preoccupied with tax, not good sound investments.

Changes are not due to take effect until 1 April 2007 and at this stage there is no need for any action. If the changes proceed, we will review all our client portfolios to explain any impact and to make appropriate suggestions.

Recognition in the media

> "The judges commented Susanna "presents a refreshing perspective on financial issues"."

At the recent annual NZ Magazine of the Year awards, Susanna Stuart won the Columnist of the Year title in the Contract category for her column, Money Talks, in NEXT magazine.

The judges commented Susanna "presents a refreshing perspective on financial issues." This year marks the 10th year that Susanna has been writing for Next. A question frequently asked of her is "how do you come up with a topic every month?"

Her answer: "Money is essentially about people and what it means for them, and their families. New Zealand has four million money stories."

And watch out for Deborah Carlyon appearing on Fair Go, The Money Special, on the 28 June on TVOne at 7.30pm. We are quick to point out she is not the subject of a Fair Go investigation; instead she will be dispensing expert advice to individuals with a range of money issues.

Market update

The strong surge in global equity markets came to an abrupt end in early May amidst concerns about higher inflation. The World Index in NZ dollar terms was down 3.4% in May but this is off the back of a huge gain of 43% for the year to April.

What does this mean for New Zealand investors?

- There was little change in the NZ dollar since the significant fall in March. It is slightly down since our last newsletter as at 31 May.
- The NZ share market also weakened – a situation made worse by the Telecom fallout. Proposed Government regulations will directly and adversely impact Telecom.
- The Reserve Bank kept the official Cash Rate (OCR) at 7.25% signaling that it is unlikely to do any easing this year despite a weaker than expected economy. Our short term inflation is up mainly due to high oil prices and any price fall may prompt the Reserve Bank to ease interest rates sooner.
- According to a Colmar Brunton survey, consumer confidence fell to its lowest level in 15 years. They blame oil prices and weaker labour markets.
- The weather bomb of mid-June has also dented business activity and confidence.

What does this mean for our client portfolios?

- Our same message – stay diversified, global shares remain attractive over the long term.
- In upcoming client reviews, there will be some rebalancing of portfolios particularly for those clients who are drawing down both income and capital.
- Given short term inflation pressures, we have put more emphasis on shorter term fixed interest deposits.

A reminder about risk and return

The collapse of a second finance company exposed to the used car market – Provincial Finance Ltd – is a timely reminder of the relationship between risk and return. Investors frequently make the mistake of focusing on the high interest return and not understanding why it is high.

Although Provincial Finance Ltd offered depositors a secured debenture rate, this assumes the assets providing the security have held their value in the event of the company winding up.

When designing investment portfolios we have always stuck with "A" rated fixed interest securities rated by Standard & Poors (S&P) or Moodys. The only finance company we use is UDC Finance which lends to a wide range of industries including transport, agriculture, manufacturing, construction and government.

The types of assets which secure its lending include plant, printing and IT equipment, motor vehicles and the heavy machinery you see in road works. Car finance is a small proportion of UDC's business. S&P rates it "AA-".

Institute of Financial Advisers

Deborah & Susanna are members of the Financial Planners & Insurance Advisers Association (FPIA) which is the main industry association. Recently it changed its name to the more elegant title: Institute of Financial Advisers. It is through the Institute we maintain our registrations as Certified Financial Planner^{CM} practitioners. The CFP^{CM} mark is a world standard for financial planning professionals.

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