STUART + CARLYON

Financial advisers for your lifetime goals

New ground rules

We recently attended a conference on Portfolio Construction and it's always the sessions on geopolitics that are the most interesting.

One prominent speaker was Jonathan Pain, editor of The Pain Report, who provides an independent and global perspective of markets and the world economy. It was certainly an aptly named report in the wake of the Global Financial Crisis, but the author has long been worth listening to. He's passionate about the emerging nations and the importance of their role often underplayed and under-reported in the developed nations. Says Pain: instead of worrying about what Europe is doing we should look at Asia, Africa and South America and the changes that are happening there.

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He is wry about the financial hand-wringing in the west. Reported Pain: "I found it particularly ironic that the day the EU announced its 10 billion euro bailout of Cyprus, the Chinese announced plans to build a 10 billion dollar port in Tanzania. The former was the breaking news headline across the western world whilst the latter did not get a mention."

"Africa, the birthplace of humanity and with the world's most youthful population, is home to one billion people and is witnessing a seismic transformation, both political and economic, which is great news for all its people and the broader global community."

On these grounds he exhorted us to stay positive. In fact he is even more optimistic on the US economy with a forecast of 3% growth in 2013 with housing being a contributor to growth and improving business and consumer confidence.

His thinking, shared by many, has given us plenty to think about. You will notice at your next review we will be looking at adding specific exposure to emerging markets in order to shore up future growth in our portfolios.

Companies in developed and mature markets will struggle to grow earnings in contrast to those in emerging markets, in particular the Asian nations that have low government debt. Those companies – which include both local and multinational brands – with a presence in these unencumbered economies should do well.

As you may know we use farrelly's asset allocation process for determining how much exposure your portfolio should have to cash, fixed interest, shares and property. This process affirms the story we're hearing from experts such as Jonathan Pain.

- The overseas shares sector has now become a tale of two markets: the developed versus emerging. The emerging markets sector is currently underperforming so we expect better returns coming from a cheaper base than the developed sector which has rallied strongly recently. The split is half and half.
- There are still some risks with emerging markets: political and governance. These populous nations like China also have their challenges (pollution) and will soon have to pay the price of industrialization, as the west did in the 80 and 90s.
- There is a strong case to diversify in order to reduce exposure to the fragile state of the developed markets and the weak global banking system.
- Our client portfolios will already have exposure to companies with a presence in the emerging markets but we will be dialing up the weighting given to these.

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The bottom line is this. The expected returns (and this can never be a promise) from emerging markets are looking better than those for developed markets. Based on current assumptions, the average GDP growth in Asia and Africa will be around 6% pa real compared to 2% in developed countries over the next decade.

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Does your tax exposure suffer jet lag?

Working overseas usually involves contributing to a super scheme as part of the employment package. If you are back here working, you probably left your foreign scheme behind. If you are retired, you may have withdrawn funds already. There are tax changes afoot that may interest you (or pass this on if you have family who've worked offshore).

Has an overseas scheme ever been taxable for New Zealand residents? Well, if it is in Australia, the answer is no – thanks to our Closer Economic Relations policy. Any other country comes with a complex set of rules. If taxable here, it was likely included in the Foreign Investment Fund (FIF) regime and taxed each year as if it earned 5%. In case you hadn't noticed, New Zealand taxes its residents on their world wide income each year – even if the income doesn't actually make it to our shores.

It's fair to say, there's been general confusion over the years. Do the FIF rules apply or not; if not, should your foreign super scheme be declared in tax returns and if so, when? Confusion has lead to non-compliance for some taxpayers.

Clarity is looming. There is a new tax bill in Parliament and it proposes one set of rules for all New Zealand residents with foreign superannuation schemes. From 1 April 2014, they will all be taxed, but only upon receipt – that means when withdrawn or transferred to a local scheme such as KiwiSaver or when you receive overseas pension income (that's always been taxable).

Australian super transfers will remain tax exempt. There's a further exemption for all new migrants and New Zealanders returning, but only if they transfer within their first four years of residency.

After the four year exemption period, tax kicks in. The "schedule method" deems a certain amount of the lump sum received as investment gains, based on "assessable" years of residence. The rate is around 5% per year so as an example: after three "assessable" years, 15% of the transfer sum is taxable; if you transfer $100,000, add $15,000 taxable income to your tax return; at 33% tax rate, you will pay $5,000 tax in the year you transfer your foreign super.

As you can see, the taxable sums get bigger the longer you keep your foreign super scheme offshore.

SCHEDULE METHOD	
Assessable years of residence	Taxable part of lump sum
1 - 4	5% - 18%
5 - 8	23% - 36%
9 - 12	40% - 52%
13 - 16	56% - 68%
17 - 20	72% - 82%
21 - 25	86% - 99%
26 years +	100%

IRD's viewpoint: if you had transferred it to New Zealand, tax would've been paid here on the investment gains so there should be no tax advantage in keeping your super offshore.

Relief is at hand though. There's an amnesty period during which you can pay tax on only 15% of the funds, no matter how long you have been in NZ with an undeclared foreign super scheme. However, you must have withdrawn or transferred the scheme between 1 January 2000 and 31 March 2014. Then you have until your 2014 or 2015 tax return to declare the taxable income. This is helpful because it gives you time to plan for the tax liability.

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There is a second "formula method" – track your total scheme contributions to isolate capital invested from the returns, and pay tax only on the actual gain since you became resident. Thirdly, you can leave your super scheme overseas until retirement and draw regular taxable pension income.

If this affects you, potential action may be required soon, especially if you need to transfer a scheme because that can take months to complete.

We suggest some analysis first to see whether you should:

- Transfer your foreign scheme before 31 March 2014 and declare 15% taxable
- Leave it and take a pension when you retire
- Declare 15% taxable from a previous transfer
- Use the "formula method" to see if the taxable portion is less than 15%

This is a simplified version of the proposals and we recommend you consult an accountant. In the meantime, we are proposing a presentation by the tax specialists at PWC. We welcome our clients, and their family members who have worked overseas, and accountants and solicitors who have clients in this position. We'd like to gauge interest so please email or phone us if you'd like to attend.