ETF taxation report for investors 2019

New Zealand

Commissioned by:
HKEX
香港交易所

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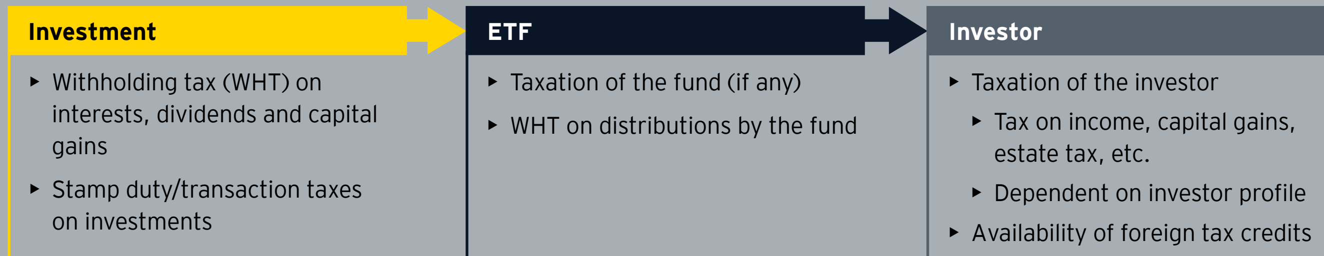
Introduction

Exchange Traded Funds (ETFs) continue to gain popularity by investors as an efficient mechanism to gain a broad array of desired market access. Whilst return on investment (ROI) is a key priority, costs play an important role in maximizing ROI. One significant yet lesser understood cost with investing in ETFs is taxation. This is especially true for any cross-border investments which are normally subject to multiple instances of taxation.

In this report we will examine the impact of different types of ETFs on New Zealand based investor returns across key markets, ETF types and domiciles.

Multiple instances of taxation on ETFs

An investor's ETF returns can generally be subject to tax at three levels:



The extent of tax costs will vary widely depending on:

1. Domicile and type of investor
2. Domicile and type of ETF*
3. Jurisdiction of the underlying portfolio investments

* Especially important because this should have an impact on the following:

- The applicable WHT rate at both the investment and investor levels
- The applicable taxes at the fund level
- Access to any available tax treaty benefits

Types of ETFs compared

Common forms of ETFs compared in this report include the following:

- Hong Kong domiciled fund, listed on the HKEX
- Irish Collective Asset-management Vehicle (ICAV) authorized as an Undertaking for Collective Investment in Transferable Securities (UCIT)
- Luxembourg Société d'Investissement à Capital Variable (SICAV)/Société d'Investissement à Capital Fixe (SICAF)
- US Regulated Investment Company (RIC)
- New Zealand unit trust (New Zealand Fund)

Basis of analysis

1. General in nature
2. Only consider the impact of tax on dividend and interest income
3. Also important to consider the impact of tax on exit giving rise to capital gains and the availability of foreign tax credits

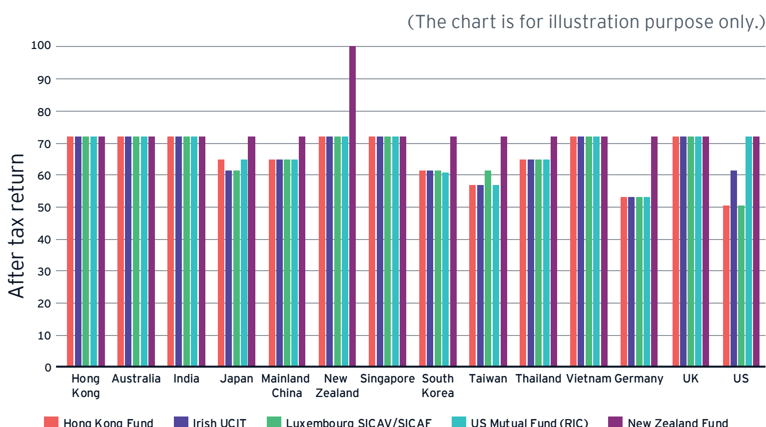
Assumptions

- The US ETF will qualify as a RIC for the relevant year and satisfy the relevant annual distribution requirements such that it should not be subject to US federal income tax on its investment company taxable income distributed to stockholders
- The Irish UCIT's principal class of shares is substantially and regularly traded on a recognized stock exchange
- All funds are eligible to enjoy the portfolio interest exemption in the US
- Luxembourg SICAV/SICAF shall not be able to avail of the Luxembourg-US tax treaty benefits, and hence statutory withholding tax rate applies on dividends from US equities
- The cash dividends from New Zealand equities and distributions made by New Zealand Fund are fully imputed
- New Zealand companies will distribute supplementary dividends to foreign ETFs
- The cash dividends from Australian equities are fully franked at standard corporate tax rate
- The Australian corporate bonds satisfy the interest withholding tax exemption requirements pursuant to Section 128F of the Income Tax Assessment Act 1936
- The dividends from foreign investments to New Zealand Fund and distributions made by foreign ETFs to New Zealand corporate investors are considered as part of the deemed income under the Foreign Investment Fund regime in New Zealand (the Australian share exemption does not apply)
- New Zealand Fund is registered as a portfolio investment entity with the New Zealand Inland Revenue Department and holds a resident withholding tax exemption certificate particularly for interest
- In making the comparison, it has been assumed that New Zealand Fund will be able to obtain a certificate of residency and be eligible for treaty benefits**
- All investors are institutional corporate investors and tax residents in New Zealand**

** Ultimately, the ability to claim treaty benefits by New Zealand investor or the ETF will depend on their individual facts and circumstances, e.g. whether they can demonstrate to the local tax authority that they are the beneficial owners of such income. These requirements should be assessed in detail.

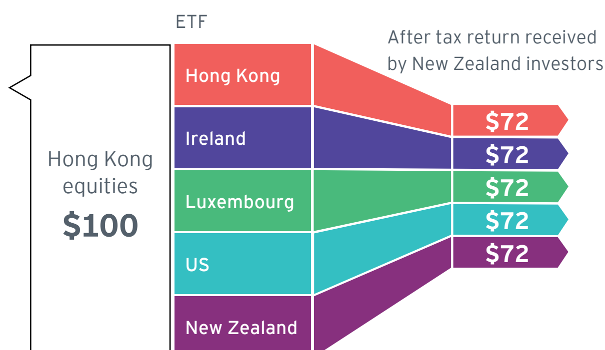
New Zealand investor after tax returns compared

Figure 1. Dividends from equities



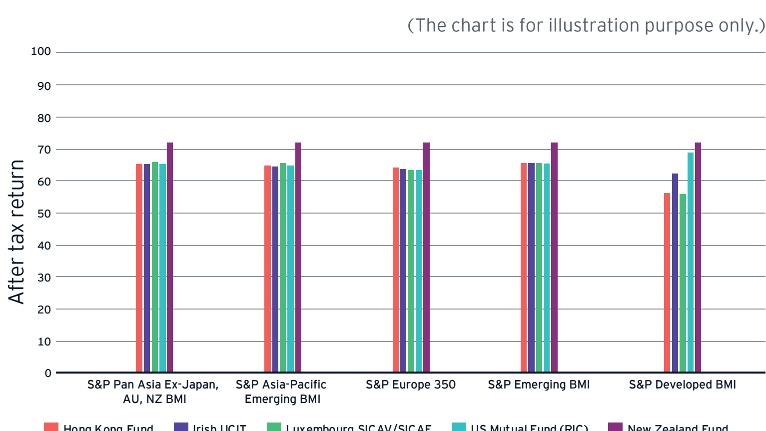
The German dividend withholding tax rate reflected above is the statutory withholding tax rate at source, i.e., 26.4%. A better outcome may be achieved where tax treaty relief can be availed.

Illustrative diagram for Hong Kong equities (Figure 1)



By investing in Hong Kong equities through a Hong Kong Fund, New Zealand investors would receive 72% after tax return for dividends, which is equally tax efficient compared to investing through ETFs domiciled in Ireland, Luxembourg, US and New Zealand.

Figure 2. Dividends from indices



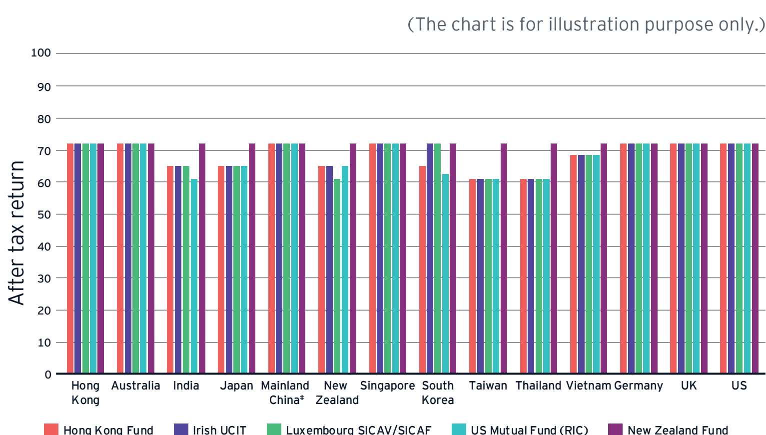
Based on index constituents' jurisdiction domicile as of 31 December 2018

Key findings

In general, New Zealand Funds are the most tax efficient ETF vehicle for New Zealand investors across all jurisdictions.

Notwithstanding the above, New Zealand investors may seek to invest into ETF vehicles domiciled outside of New Zealand for a number of non-tax reasons. For examples, potentially lower fees for investing into ETF vehicles offered in larger markets (e.g., Hong Kong, Ireland, Luxembourg and US) and wider range of underlying investments in these markets (e.g., access to Mainland China A-share through investing into Hong Kong domiciled ETFs).

Figure 3. Interest from corporate bonds



Non-resident institutional investors are temporarily exempt from WHT with respect to interest income derived from Mainland China corporate bonds (up to 6 November 2021).

Conclusion

Hong Kong domiciled ETFs have traditionally been recognized for their unique access to the domestic market of Mainland China. However, with the HKEX now carrying over 130 ETFs[1] representing a wide range of global markets, investors now have an enhanced ability to use Hong Kong ETFs to achieve their desired market exposures.

Furthermore, Hong Kong's expanding treaty network and domestic tax rules offer significant benefits for investors seeking to invest via Hong Kong ETFs to gain exposure to other Asian and global markets.

1. Source: HKEX official webpage (September 2019)

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