

ASFONZ

(The Association of Superannuation Funds of New Zealand)

Submission on the IRD and Treasury issues paper

“Countering extreme salary sacrifice

Ensuring that employer superannuation contributions are taxed fairly”

18 March 2006

1. Introduction

ASFONZ welcomes the opportunity to comment on the Officials' proposals to address the fairness issue created by employees receiving very significant portions of their remuneration by way of employer superannuation contributions which have been subject to progressive rates of SSCWT.

The need to make changes to this legislation comes as no surprise. The current tiered SSCWT rates regime was never the subject of industry consultation, with last minute changes to the form of the proposals being made in the final stages of the legislative process in early 2004.

With that experience in mind, we urge officials to do what they can to ensure that common sense and expertise prevail to minimise the continuing need for "band-aid" legislation of the currently proposed kind.

The proposals set out in the issues paper lack detail – we raise some of our resulting concerns in this submission but would welcome the opportunity to develop these further. We strongly recommend a considered, step by step approach to resolving any identified issues. We suggest, in particular, that we see the detail of the legislative changes proposed before they are presented in a Bill format. Our past experience is that changes to a Bill to prevent unintended consequences are more difficult than addressing those consequences in draft form before a Bill is tabled in Parliament. We can assure officials of appropriate confidentiality. Our only objective is to have a regime that works and that is practical. We think that ASFONZ is uniquely placed to assist in this way.

One final introductory point – before legislation is proposed and passed, we would like to understand the scale of the problem that "extreme" salary sacrifice has apparently caused. We have been given conflicting explanations on this. Some officials apparently think there is no evidence of material revenue loss from "extreme" salary sacrifice so we think there needs to be much better information available. There is nothing in the issues paper itself.

The significance or immediacy of the problem bears on the need for legislative urgency to address the problem. As we have said above, the need to change comes as no surprise. However, the speed with which change is needed should be the subject of debate. This is a technical area and we think that care is required to ensure any solution is the right one and that unintended consequences of the kind the issues paper describes are best avoided.

2. An alternative approach

The proposals as set out in the issues paper look to make ostensibly cosmetic changes to the method by which specified superannuation contribution withholding tax ("SSCWT") is levied. The calculation obligation remains with the employer, albeit on new, more complex, rules. At best, these new rules will produce a reasonable result from a tax base maintenance perspective.

We are concerned that having described the potential problem with the current framework, the issues paper describes only a single solution. We think that proposal is not the only way to address "extreme" salary sacrifice.

In Part 2 of our submission of 30 September 2005 on the discussion document concerning taxation of investment income, we proposed a model that places the IRD in the position of being the final arbiter of matters relating to tax for superannuation schemes in relation to the individual members of those schemes. We repeat that section of our submission in the Appendix for your information.

If policymakers want employers to come to the KiwiSaver party and make contributions on behalf of employees then this process needs to be made as simple as possible. The remission of gross amounts by an employer, with the IRD determining and deducting any appropriate tax before forwarding the net contributions to the KiwiSaver provider, would provide such simplicity. Only the IRD (not the remitting employer) knows with the requisite certainty how much taxable income the member receives and, with KiwiSaver, the IRD will also know any additional remuneration that the employer contributes to superannuation. It would therefore be a relatively straightforward process for the IRD to deduct the appropriate amount of income tax (not SSCWT) before passing the net amount on to the KiwiSaver provider. That would be an end to the member's potential liability for tax on indirect remuneration, and would also avoid the need for the employer's involvement in this process.

This proposal would also eliminate the need for fund withdrawal tax, with all its largely valueless complexity.

The rules as proposed will not be conducive to employers agreeing to make contributions to KiwiSaver schemes.

We encourage officials to think about this issue from a broader perspective.

3. A further (less radical) alternative

The paper suggests that the objective of the changes is solely to counter the potential for extreme salary sacrifice, and yet the measures proposed will alter the method for determining the rate of SSCWT for employees at all levels of remuneration. We are concerned that the additional complexity of administering the proposals will result in many of the employers who have moved to using progressive SSCWT rates simply reverting to the flat 33% rate. This would make the proposal pointless.

As an alternative, we propose that the current progressive regime remains but subject to a requirement that the rate be 33% in respect of any employee for whom the annual gross employer superannuation contributions in the previous financial year (or expected in the next year for a new employee) exceed a specified percentage of his or her taxable income from that employer. The percentage could be 15% following the rationale set out in the issues paper - or some higher amount if the intention is truly to prevent excessive amounts being sacrificed. The suggested 15% figure, which is congruent with the proposals in the paper itself, is really intended to accommodate a "normal" employer contribution rather than to tackle "extreme" salary sacrifice.

Another option could be to require that the rate of 33% apply if the value of the remuneration package of the employee exceeds a fixed amount (say \$100,000). This has less appeal as it assumes all employers operate their pay systems on a total remuneration structure and this is not necessarily the case.

4. Issues that need to be considered

4.1 Employment records

The proposal will require employers to hold details of the gross employer contributions remitted to schemes over the previous tax year. At present this information is not required to be held within a payroll system. We suspect that many payrolls would need to have this functionality added.

Changing major payroll systems is normally complex and expensive. Salary sacrifice (not just “extreme” versions of that) requires payrolls to keep two definitions of “pay”. Many systems cannot do that, and those that now do have been expensive to adapt.

The issue paper’s solution will require employers to keep a third definition – not just “remuneration” and “remuneration net of sacrifice” but also “remuneration for PAYE and SSCWT purposes”. So, if an employer wished to retain variable SSCWT, the demands on the payroll system created by the issues paper’s recommendation may force the employer back to the single 33% rate. Perhaps that is what the issues paper anticipates as the likely employer response. If so, it would be simpler to state that we will return to the previous single SSCWT rate of 33%.

4.2 Contributions from Reserve Accounts

What happens if employer contributions are met from a scheme’s reserves for any period of time? Will the progressive SSCWT rate be determined as if the employer had made contributions during that period – or not? Depending on the approach taken this may result in fluctuating rates of SSCWT from year to year even though the member’s taxable salary is stable.

Similar volatility may arise if one-off bonuses, significant pay rises or overtime are paid to employees (whether or not these attract employer contributions.)

4.3 New employees

What method will be used to determine the appropriate rate of SSCWT for new employees – expected taxable salary plus expected gross employer contributions? Will this be annualised? (it is not under current legislation.)

4.4 Treatment of employees with multiple jobs

How will employees with multiple sources of income be treated? At present only employment income from the remitting employer is taken into account. Will this approach be retained?

4.5 Unallocated schemes

How will the proposals work for defined benefit schemes or for unallocated cash accumulation schemes where, in each case, contributions are not specifically allocated to individual members?

4.6 Uneven lifetime saving patterns

The current public policy framework leaves the saving decision to individuals with, perhaps, assistance from employers. Individuals have different capacities to save at different stages of their working lives. During the early part (capital formation, borrowing for education and housing), saving specifically for retirement income is inappropriate unless subsidised. At later stages, when disposable incomes are higher and both financial and education-related liabilities have likely been reduced or eliminated, quite significant amounts of income can (and should) be set aside for retirement income. Salary sacrifice is one way of making those savings but the signal sent by the issues paper is based on a relatively low (net 10%) contribution from the employer over the employee's working life. We suggest that such a signal may be inappropriate.

5. Further assistance

We will be pleased to consult further on the issues raised in this submission.

Our organisation

The Association of Superannuation Funds of New Zealand Inc. ("ASFONZ")

ASFONZ is an independent national, non-profit organisation founded in 1969. Its current membership comprises around 100 major workplace superannuation schemes and around 50 organisations and individuals representing the various product and service providers for workplace superannuation.

The mission of ASFONZ is to promote workplace superannuation in New Zealand.

ASFONZ seeks to achieve that mission through:

- 1 **Advocacy** – being the recognised voice for all employers and trustees involved in workplace superannuation, through:
 - (i) advocating legislative and public policy initiatives beneficial to the industry;
 - (ii) making submissions and commentary on existing legislative and public policy initiatives;
 - (iii) issuing regular press releases and other public commentary on matters of wider concern or interest to members; and
 - (iv) staying in regular contact with responsible Ministers, regulatory and industry bodies, the Retirement Commissioner and Government Departments to project, promote and advance members' interests.
- 2 **Education** – promoting trustee, employer and member education through dedicated training programmes, newsletters and special interest seminars.
- 3 **Networking** – providing trustees, employers and service providers involved in workplace superannuation with a regular forum for sharing ideas and information on industry matters.

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APPENDIX – Extract from Part 2 of the ASFONZ submission on the discussion document concerning Taxation of investment income

Chapter 4 – Proposals to Achieve Neutrality and Align Marginal Tax Rates

4(i) An alternative proposal – who should be responsible for final tax calculations?

Chapter 4 of the Discussion Document sets out the mechanics for the “flow-through” model. The objective is to align the rate of taxation on investment income with a rate appropriate to the marginal tax rate of the individual.

The proposals in the Discussion Document impose the tax administration burden squarely on the trustees and providers of QCIVs. We believe that this role more appropriately falls within the responsibility of the IRD and that a model with the IRD at its core will improve the efficiency and accuracy (and therefore fairness) of the final result.

In Part 1 of our submission, we suggested an alternative proposal. Our proposed alternative is described below and has features similar to the withholding tax system that applies to millions of New Zealand bank accounts:

1. Investors provide IRD numbers to QCIV providers on entry, and if appropriate (depending on whether optional withholding tax rates are offered by the QCIV) nominate a withholding tax rate. If no IRD number is provided, the top withholding tax rate applies (39%). A possible variation would be for new members and/or existing members to be required to provide IRD numbers as a condition of entry.
2. On attribution dates, the QCIV providers deduct withholding tax at the nominated or default rate and this is remitted to the Inland Revenue. We suspect that for ease of administration, and to minimise administration costs, some QCIVs might choose not to offer a choice of rates and would apply the same rate across all investors.

The IRD could regulate this so that vehicles were required to use the withholding tax rate expected to minimise the numbers of investors or investor accounts that IRD would later need to deal with.

3. At the end of year, and on final exit from the QCIV, the QCIV provider would provide the investor and the IRD with summarised details of the transactions through the investor’s account. This would include the gross income, deductible expenses, imputation credits, foreign tax credits and withholding tax deductions. Under the new taxation regime, collective investment vehicles will no longer accumulate deferred tax assets and liabilities, so only transitional measures will be required to accommodate any residual tax losses currently held by collective vehicles.

4. The IRD would then match the investor's QCIV details with the taxpayer's file and determine whether there was further tax to pay, or whether a credit was due. To avoid the need for taxpayers to file returns the "square-up" process would take place between the IRD and the QCIV with credits being applied to the investor's account in the QCIV and tax payments being deducted from the investor's accounts. The end of year file supplied to the IRD would note exited investors and the IRD would need to deal directly with such taxpayers in respect of the "square-up" process. We envisage that QCIV providers would warn exiting investors of their potential tax obligations.

These proposals represent a significant change from current practice and would necessitate significant changes to systems to accommodate the "flow-through" aspects of the model (see the comments on the complexity of flow through administration made in the 2nd paragraph of section 4(vii) below. Similar issues are relevant here). The IRD would also need to modify its systems to manage the square-up process. QCIVs should be permitted to use IRD number of the investor as a unique identifier to simplify the matching process. We understand that the Australian Tax Office runs aspects of its superannuation taxation system using a similar approach, in which money transfers are managed between the scheme and the ATO without the need for direct involvement of the taxpayer in most cases.

Despite the inherent complexities, we think that this proposal offers a better result than the "flow-through" model described in the Discussion Document. Our reasons for this include:

- a) The entity with access to an individual's tax records is responsible for the final tax determination. This moves the burden from a large number of providers of QCIVs to a central body.
- b) Responsibility for an individual's losses, excess imputation credits and the like falls to the IRD. This will improve portability for investors between QCIVs as they will no longer forfeit tax credits held in particular QCIVs and will reduce the complexity for the providers of QCIVs with each such provider maintaining such details for each of its investors.
- c) It removes the need to set arbitrary tax thresholds as proposed in the Discussion Document's model because the final tax is imposed at the correct marginal tax rate for the investor. The obligation on QCIV providers to collect information each year from taxpayers is removed, although those that offer optional withholding tax rates may still choose to do this and to vary the rates at the request of the investor. A pragmatic approach to timing issues should be taken to avoid complex use of money interest issues.
- d) The information held by the IRD will enable policymakers to make robust policy decisions, as income information that would otherwise not be made available will now reside in the tax-payer's file. The Discussion Document takes an unusual stance on the relationship between returns from a QCIV and social policy initiatives.

At paragraph 4.86, we read:

More importantly, the requirement for investors in a QCIV to file a return would also affect a number of social policy initiatives that are delivered or collected through the tax system. They include:

- *payment of family assistance;*
- *collection of child support payments;*
- *student loan repayments.”*

In our view, income arising in QCIVs should be considered when developing social policy initiatives. The fact that information is made available does not of necessity mean that the information needs to be taken into account in determining the payments made to or required from a taxpayer. Under previous legislation only 50% of a pension from a registered superannuation scheme was taken into account in determining a person’s New Zealand Superannuation entitlement under the “surcharge” provisions. With advances in technology, we are sure that policy decisions on the extent to which QCIV income is taken into account could be managed.

- e) The model offers an optional extra. At present, employer contributions to superannuation schemes are subject to SSCWT at rates which, at the employer’s election, may be set to reflect the income paid to an employee in the preceding income tax year. The mechanics of this have led growth in the practice referred to as “salary sacrifice”. Under a salary sacrifice arrangement, an employee can forgo salary for future pay periods in exchange for employer contributions to a registered superannuation scheme which are then taxed at a full and final SSCWT rate lower than that of the PAYE tax that would otherwise be payable. The tax avoidance opportunity this creates has led to complex Fund Withdrawal Tax legislation.

With the information transfer to the IRD in place for investment income, it would be a relatively simple extension for the information and money flow between the QCIV and the IRD to include details and deductions in respect of the employer contributions made on behalf of the employee. Policy options for managing or removing the “salary sacrifice” option would become available under such a system that simply cannot be managed from a logistical perspective under the current model. The obligation to manage SSCWT would be removed from the employer. This is likely to make it more attractive for employers to make contributions to KiwiSaver schemes on behalf of employees. The need for superannuation schemes to manage the complex process of calculating and remitting Fund Withdrawal Tax, “FWT” (pointless complexity in most cases, as FWT liabilities are almost never triggered given the available range of exemptions) would also disappear.

Adopting this proposal would still involve considerable amendments to systems and processes, at some cost. Nonetheless, we believe that it would result in a much more robust and fairer system. Issues relating to unvested amounts and defined benefit entitlements would need to be resolved with either proposal.