

Submission on:

“Social assistance integrity: defining family income”

26 October 2010

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1. Introduction

The officials' Issues Paper *Social assistance integrity: defining family income (Inland Revenue & New Zealand Treasury, 2010)* suggests "...changes to improve the fairness of access to social assistance programmes". It was foreshadowed in the 2010 Budget.

The Issues Paper proposes to extend the definition of 'income' when someone may be entitled to an income-tested benefit such as Working For Families, Student Allowances etc. Some income that is not directly earned by the applicant (or the household) will now be included.

2. The need for change

There is no doubt that the way income is defined for the purposes of the Social Security Act 1964 needs changing because it is so easy to 'hide' income to maximise entitlements to income-tested benefits. It seems wrong in principle that someone can improve their entitlements to income-tested benefits by changing the amount of their directly received income without diminishing the household's economic income.

Part of the reason for the need to change the definition of 'family income' derives from fragmented, structural changes to the income tax system itself over recent years. Taxpayers now have more choices about how they receive income and sometimes, those choices can involve vehicles that are 'final' taxpayers and that have no connection to the taxpayer's personal tax return.

3. The problem is principally with tax

However, the problems that underpin the Issues Paper do not just apply to the "social assistance programmes" referred to in the Issues Paper. They apply to the calculation of income tax as well. It is just as easy to avoid tax by splitting assets and income across different tax vehicles.

- (a) Attached as **Appendix 1** is a copy of *PensionBriefing 2009-4* that illustrates how a couple can arrange a \$5 million asset to minimise income tax under current rules.
- (b) It is even possible to 'shelter' employment income from full tax. Attached as **Appendix 2** is a copy of *PensionBriefing 2009-3* that illustrates how a highly paid employee can re-arrange employment income to minimise income tax under current rules.

Note: Both of the attachments were written in 2009 and reflect the tax rates then applicable. While the specific amounts of tax payable will have changed, the principles of structuring 'income' and 'remuneration' have not.

What we have at present with particular regard to different saving vehicles and instruments is the result of decades of patches, compromises and the creation of new saving vehicles (most recently PIEs) with their own tax treatments.

An RPRC Working Paper by Chamberlain & Littlewood (Chamberlain & Littlewood, 2010) analysed all the definitions of 'income' that now apply to the taxation of investments. They describe the current tax arrangements as being the product of a 'silo approach' to the development and changing of tax rules. Each set of rules has been developed on its own without real regard to the whole.

Taking the example of a single Australian-listed share, Chamberlain & Littlewood show 11 different ways that single share can be owned either directly or through combinations of unit trusts, registered superannuation schemes and Portfolio Investment Entities (PIEs). The results are also affected by the artificial concept of the 'Fair Dividend Rate' (FDR) that has no connection with ordinary concepts of 'income'.

As a result, there are *seven* different tax consequences of those choices with respect to that single overseas share.

For a single overseas bond, there are 13 different ownership possibilities with, potentially, *nine* different tax consequences; that means nine different ways of calculating tax on what is, ultimately, a single investment asset.

Chamberlain & Littlewood show that the tax treatment of savings (either direct or through combinations of different vehicles, each with different tax treatments) is inconsistent and needs urgent attention.

As Chamberlain & Littlewood also point out, the problems created by the 'silo approach' to calculating 'income' also have consequences for income-tested benefits under the welfare system and the Issues Paper now acknowledges that.

However, the Issues Paper is not really about "improv[ing] fairness of access to social assistance programmes". It is in fact about fixing the inconsistencies created by all the different definitions of income used in the various tax silos as well as their disconnections from what individuals actually pay income tax on.

Here is what Chamberlain & Littlewood said about how the now acknowledged difficulties (what the paper describes as a need for "greater integrity") should be fixed:

"This paper recommends a broad framework to replace current arrangements that does not require the invention of artificial definitions of income. Instead, it attempts to recognise the true economic nature of the transactions involved. Adopting a principles-based framework will also make the interaction between 'income' and income-tested payments and levies of all kinds by the state more coherent and fairer.

The [paper's] recommended CIV [collective investment vehicles] tax regime requires that investor/members are taxed on the basis that they had earned the income directly. A practical foundation that will see the income of investor/members calculated in ways that will be familiar to taxpayers is suggested."

4. The Issues Paper's 'solution'

Rather than suggesting a principles-based approach to a complex problem (not of the welfare system's making), the Issues Paper recommends that the gaps between the different tax silos should be bridged with a new raft of artificial concepts.

In summary, the Issues Paper proposes widening significantly the current definition of 'Family Scheme Income' (FSI) to include all kinds of indirectly earned income. Because this is a prescriptive, rules-based approach to the problem, there will inevitably be another web of complexities, gaps, increased administration and disconnects.

For example, the Issues Paper proposes that investment income earned through a KiwiSaver scheme or a superannuation scheme will not be FSI and so will not count in welfare income tests whereas income earned through what the paper describes as an

'unlocked PIE' will count. It is difficult to see how that distinction can be justified. Why doesn't all income, however and wherever earned count?

FSI is not a new concept and already includes amounts received that are not usually taxable. Amounts such as child support, some overseas pensions and other distributions are already part of FSI. Also, FSI cannot currently be reduced by some types of business losses.

The Issues Paper proposes a much more complicated test than now: FSI will now also include:

- "trustee income" (TI);
- "attributable fringe benefits" (AFB);
- "passive income of children" (PIC);
- "unlocked PIE income" (uPIEi);
- "non-resident spouse income" (NrSI);
- "exempt income" (EI);
- "main income equalisation scheme deposits" (MIESD) and
- "periodic payments" (PP).

So, before a person can work out what amount of income-tested benefit they might be entitled to, someone (most certainly this will be beyond the individual's capacity) must total:

Taxable income + (TI + AFB + PIC + uPIEi + NrSI + EI + MIESD + PP + the other adjustments already made)

...in order to see how much their FSI is.

Only then can someone else (inevitably that will have to be a different person) work out what welfare the individual is entitled to. It must be recognised that, for many people, the source of information will not be readily accessible. Attributed fringe benefits, for example, may only be known by the accounting department of the employee's employer.

5. A preferred approach

As acknowledged, the conceptual difficulties described in the Issues Paper need attention. However, there is a better alternative that is principles-based and more equitable.

The first priority should be to fix the calculation of income tax so that all New Zealanders (not just potential welfare beneficiaries) pay the appropriate amount of tax on all their income, including employment receipts and investment income earned indirectly. That is a more urgent problem than "improv[ing] the fairness of access to social assistance programmes" because it applies to all taxpayers, not just those potentially entitled to income-tested benefits.

Fixing income tax (and taxing all income, however and wherever earned) will automatically attend to the current problems with income-tested welfare benefits. The Issue Paper's objective must be achieved but it is actually a second-order problem.

If all 'income' were appropriately taxed then the Inland Revenue would automatically know whether the taxpayer qualifies for an income-tested benefit; and the income tax system itself will be fairer.

Having a fairer tax system is surely more important than "improv[ing] the fairness of access to social assistance programmes". Both problems need fixing but the tax

system's problem is more important than the 'fairness in welfare' problems described in the Issues Paper.

Here is what the Issues Paper states (in paragraph 1.2):

"People should not receive different levels of assistance according to how they structure their affairs or the manner in which they receive income to live on – this is inequitable"

The RPRC agrees with this but consider this statement:

"People should not *pay* different levels of *tax* according to how they structure their affairs or the manner in which they receive income to live on – this is inequitable"

The two changed words have been italicised. The second statement is, we suggest, of greater significance than the first. The Issues Paper impliedly suggests that New Zealand should accept the inequities of individuals' re-structuring their affairs to reduce tax and instead invent a complex set of artificial rules to control the implications of that restructuring within the welfare system.

6. Chamberlain & Littlewood's paper

For the record, accompanying this submission is the paper by Chamberlain & Littlewood already referred to.

Here is how Chamberlain & Littlewood (p. 28) summed up the current income tax arrangements:

"The discontinuities between different parts of the CIV regime, the illogical tax treatment of contributions and investment income and the artificial distinctions between directly and indirectly earned income mean, inevitably, that the 2007 rules will be subject to change as advisers test the boundaries. As is usually the case, wealthier taxpayers will benefit the most as they rearrange their affairs to best tax advantage. They should capture the KiwiSaver-related concessions and invest the rest either in a PIE or in a superannuation scheme that invests in a PIE. They should not invest directly.

Along the way, the tax system seems to have lost the natural meaning of 'income'. In a progressive tax regime, how much total 'income' an individual receives matters to the system's integrity. 'Investment income' needs, potentially, to have no clear connection with the member's economic capacity to pay tax. If this basic principle had been set aside for practical considerations, that might have been justifiable. Regrettably, that was not the case."

7. In conclusion

New Zealand's taxpayers deserve better than the current arrangements. The reforms suggested by the Issues Paper will apply regulatory sticking plaster to some (but not all) of the current manifestations of the problems without, however, addressing the main issues. Inevitably, new problems will arise with the new rules as financial planners and other advisers test the detail.

The proposals also introduce a level of complexity that must create a material layer of compliance costs.

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 split (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 return¹. 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 entities². 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).

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

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.

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 involved³. 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.

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.

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

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.

Structuring remuneration to maximise value through 'salary sacrifice'

RPRC *PensionBriefing* 2009-3

This *PensionBriefing* outlines the way in which remuneration can be structured to maximise the net income without extra cost to employers. It updates *PensionBriefing 02/2008* with recent changes in income tax and KiwiSaver.

The tax treatment of superannuation (KiwiSaver and the PIE regime) mean that employees can improve the after-tax value of their remuneration. Whether this is good public policy is questionable but there is no doubt about the potential financial gains to employees at the expense of other taxpayers.

This can get quite complicated, hence the need for advice, so what follows is an overview of the highlights. To make the case simple, we assume the employee is paid \$150,000 a year; has no current superannuation benefits but has an employer that is prepared to re-arrange things for the employee's benefit on a cost-neutral basis. The employee has also decided to put serious amounts aside for retirement.

There are four possible cases:

- (a) the employee does nothing;
- (b) the employee 'salary sacrifices' to join just KiwiSaver;
- (c) the employee 'salary sacrifices' to join a regular superannuation scheme (and doesn't join KiwiSaver);
- (d) the employee maximises the value of salary sacrifice and joins both KiwiSaver and a regular superannuation scheme.

We will look at just case (a) – do nothing – and case (d) – do everything – to illustrate the possibilities. In every case, it is possible for the outcome to be cost neutral to the employer. That is the underpinning basis for what follows.

Under the KiwiSaver amendments passed in December 2008, the employer and employee can agree to maintain a "total remuneration" approach, including the compulsory employer contributions to KiwiSaver. They can be included in remuneration of \$150,000 and do not have to be paid on top of pay. Given that the 'compulsory' contributions can be financed out of pay increases that the employer would otherwise have been given, the employer has control of this issue as far as the 'agreement' is concerned. We will assume for the example that the employer has adopted this "total remuneration" approach.

Here is the present position:

Gross taxable pay	\$150,000
Less tax	\$46,550
Less ACC levy ⁵	<u>\$1,810</u>
Net income	\$101,640

⁵ 1.7% on taxable pay up to \$106,473 a year.

From the pure viewpoint of tax, the optimal taxable pay that the employee should receive is \$70,000 a year. That's because any income above that is taxed at 38% whereas the maximum tax rate on sacrificed pay is 33%.

So, here is the list of things our employee can do, using salary sacrifice to take advantage of the tax treatment of superannuation contributions:

1. 'Sacrifice' \$80,000 a year of taxable pay from \$150,000 down to \$70,000.

Some might think that it is better to keep taxable pay as high as possible to maximise the tax-free KiwiSaver contribution by the employer. That isn't the case, as explained below. Maximising the salary sacrifice to a normal superannuation scheme is the first step in this tax-optimal restructuring.

2. Join KiwiSaver and contribute 2% of \$70,000 (\$1,400 a year from after-tax pay) – this qualifies for the government's "employee tax credit" of \$1,042.86 because the member must contribute at least \$1,042.86.
3. Use \$1,400 of the \$80,000 sacrificed under 1. above to set up the tax-free employer's contribution to KiwiSaver.
4. Have the balance of \$78,600 (\$80,000 less \$1,400) contributed by the employer to a registered superannuation scheme. These contributions will attract "employer superannuation contribution tax" (ESCT) of 33%, rather than the 38% that would have been paid on salary. That saves 5% of the amount contributed or \$3,930.
5. Reducing taxable pay in this way will also reduce the employee's ACC levy – that will come down from \$1,810 to \$1,190. However, the pay that counts for income-related benefits will also reduce from the ACC maximum of \$106,473 to \$70,000. So ACC income-related disability income cover will also reduce.

The following shows the new net value of the employee's new remuneration package.

New remuneration structure

		Net value (p.a.)
1. Pay	\$70,000	
less tax	\$16,150	
less ACC levy	<u>\$1,190</u>	\$52,660
Less KiwiSaver employee contribution	<u>\$1,400</u>	
Take home pay		\$51,260
 2. KiwiSaver contributions		
Employee		\$1,400 (from after-tax income, as above)
Employer		\$1,400 (tax free)
Plus government subsidy		<u>\$1,043</u> ("member tax credit", tax free)
Total to KiwiSaver		\$3,843
 3. Other superannuation		
Before tax	\$78,600	
Less ESCT	<u>\$25,938</u>	<u>\$52,662</u>

Total net value of package **\$107,765⁶**

Note: the KiwiSaver scheme will also receive a net \$1,000 “kick-start”.

So, with a little re-arrangement, our employee has added a net \$6,125 a year (6%) to the remuneration package (\$107,765 less \$101,640). That is the equivalent of adding a pre-tax \$9,879 a year to pay, at a marginal tax rate of 38%.

If the employee joins the right kind of “other superannuation” scheme, part of the net \$52,662 contribution can be used to meet life, disability and medical insurance costs. That will save a net 5% of these costs compared with paying them, as now, from after-tax pay.

Also, the other scheme’s money will not be locked up until age 65, as is the case with KiwiSaver. There is the possibility of paying “Fund Withdrawal Tax” on benefits taken early but, with a bit of patience, FWT is a voluntary tax and need not become payable – deferring the receipt of the benefit by two years after leaving employment is one way of avoiding this.

Of course, our employee will now be living on only a net \$51,260 a year (\$52,660 less the personal KiwiSaver contributions of \$1,400) but a net annual amount of \$56,505 will now be accumulating in superannuation benefits. That may sound unlikely but, in a two income, older household, one of the incomes could be given over largely to retirement saving. One of the couple can therefore do the retirement saving for both. The “non-saver” should, however, join KiwiSaver.

The new tax treatment for superannuation schemes will confer another advantage on our serious saver. The investment returns under a “portfolio investment entity” (PIE) will be taxed at a lower rate than the saver would have paid had returns been received directly. The “income” in both the superannuation schemes pay only 30% tax rather than the 38% that the employee would have paid had the income been received directly. As assets build quickly for our employee, that concession will become increasingly valuable.

It is now worth the while of highly paid employees to do some tax planning. Whether that’s good for the country is a serious public policy issue. There is, however, no doubt that re-arranging remuneration will be good for the employee’s financial health. Is that progress?

Footnote:

For the really serious saver, there is something more that can be done. Salary sacrificing pay from \$150,000 down to \$38,000 a year (rather than \$70,000 as in the example above) has a temporary extra benefit once the employee has completed a full financial year on that lower pay. As long as the superannuation scheme is a “Portfolio Investment Entity” (a PIE), the tax rate that will apply to the investment income earned in the PIE will be only 19.5% (rather than the 30% referred to above)⁷. Until the PIE assets are earning more than \$22,000 of taxable income, so that taxable pay and PIE income total more than \$60,000, the employee will save yet more tax. The PIE assets will probably need to be more than \$275,000 before the 30% applies. In the case of a couple, all of these amounts are doubled and once it gets to \$275,000 the salary sacrifice can be to a non-PIE to protect the PIE concession.

The ACC issue described in item 5 above of the remuneration strategy will see the levy and income-related cover reduce when taxable pay becomes \$38,000. The employee will also lose the tax break on employer contributions to KiwiSaver in respect of the extra \$32,000 (the difference between \$70,000 and \$38,000). The employer’s ACC levy will also reduce.

⁶ Had the employee just joined KiwiSaver (case (b) above), the total net value would have been only \$103,747 (\$4,018 less). That explains why salary sacrificing to just KiwiSaver is not optimal from a tax viewpoint. However, in the tax optimal case, the employer will have only \$51,260 a year to live on.

⁷ The government has announced (7 July 2009) that the marginal tax rates that apply to personal income will also, in some way, be also reflected in the PIE’s “prescribed investor rate” or PIR. There were no details as to how this might happen.

However, having such a low taxable income may mean that the employee also qualifies for the Independent Earner Tax Credit (IETC). The test for that is taxable income. The IETC of \$520 a year is payable if taxable income is less than \$44,000 a year.

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