Submission to

The Tax Working Group

from

Michael Littlewood

On:

1. Whether the preferential tax treatment of saving for retirement can be justified;

2. The inconsistent treatment of investments that might be used in the accumulation of retirement savings.

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About the submitter

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Michael was:

- A pension consultant for 25 years in London and Auckland for what is now Willis Towers Watson;
- Employee Benefits Director for nine years at Fletcher Challenge Limited;
- Founder-director of what is now SuperLife (www.SuperLife.co.nz);
- Co-founder, in 2006, of the Retirement Policy and Research Centre (www.RPRC.auckland.ac.nz);
- A member of the New Zealand government's 1991-92 Task Force on Private Provision for Retirement.
- Author of *How to create a competitive market in pensions – the international lessons* (IEA, London 1998) and many submissions, reports, op-eds and discussion papers on retirement and saving issues.

Michael retired as co-director of the RPRC in June 2015 and remains principal editor of www.PensionReforms.com, a web site that he started in 2006.

This is a personal submission

Auckland
30 April 2018

1. Background to this submission

In July 2017, Michael Chamberlain and I published a report that looked at topics related to pensions, saving and financial preparation for retirement. The report is *The Missing 2016 Review – building trust for life beyond work*. The report is on-line at www.Alt-Review.com.

The report gathered together what we know about a range of saving and retirement-related issues, identified the gaps in our knowledge and the questions that needed answering on each of the major issues.

This submission uses two of the sections from *The Missing 2016 Review* that are relevant to the Tax Working Group's deliberations:

- Section 9: On tax subsidies for saving – the original section is here;
- Section 17: Income tax and saving vehicles – all 'income' should be taxed at the appropriate marginal rates – the original section is here.

The Missing 2016 Review suggests there is much to be done in these two tax-related areas.

I have just written a brief paper that will appear in the US in the Spring issue of *The Journal of Retirement*. It's called *Governments have it wrong on pensions – personal lessons from a consulting career* and draws on my career in employee benefit consulting and also my last 30 years or so of participation in the public policy debates. It summarises the underlying messages of *The Missing 2016 Review.*

I strongly believe that governments should confine their public policy initiatives to areas that only governments have a unique capacity to influence – persuading or forcing citizens to save more than citizens want to save isn't one of those areas. Instead, governments should focus on:

- Reducing poverty in old age – governments cannot rely on private provision, even if 'compulsory', to achieve that;
- Levelling the tax playing fields so that all 'income' is taxed similarly, regardless of source;
- Levelling regulatory playing fields so that all saving vehicles with similar objectives are regulated similarly;
- Gathering impeccable, deep, accessible data that are relevant to behaviour and issues relevant to pensions, saving and retirement;
- Running information/education programmes on all of the above.

As Michael Chamberlain and I said in *The Missing 2016 Review*:

> "…with respect to retirement income policies:
>
> - There is a range of things that only the government can do – it should do those things.
> - There is another range of things that, based on the evidence, the government seems unable to do - it should stop doing those.
> - Finally, there are things that the government is doing but, based on the evidence, seem not to be effective – it should also stop doing those.
>
> This is evidence-based policy-making - if it works, based on the evidence, then do it; if it doesn't work, stop doing it. If we do not know whether it works, gather the evidence before deciding what to do. For New Zealand, this approach to policy–making on retirement incomes would be a change but it's time New Zealand tried it. Before that process can even start, there is a lot of information to gather."[1]

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[1] From the Introduction to *The Missing 2016 Review*, accessible here.

2. Summary of this submission

Section 3: Tax subsidies for saving: Tax breaks for retirement saving, such as the Member Tax Credit in KiwiSaver, are expensive, complex, inequitable, distortionary and regressive. But, worst of all, they seem not to work (raise saving levels). They could even reduce saving levels.

Section 4: Income tax and saving: The tax treatment of 'income' favours some retirement saving investments over others. Definitions of 'income' also matter for income-tested state benefits like Working for Families. These both need fixing. We suggest a 'first principles' approach to reform.

At the end of each section is a series of questions that the Tax Working Group should answer, both to explain the current tax treatment of retirement savings and to justify any changes to those arrangements.

3. On tax subsidies for saving[2]

While governments can certainly influence the ways in which people save for retirement, they seemingly cannot incentivise people to save more for retirement than they want to save. Tax-favoured Tier 2 (compulsory) or Tier 3 schemes (voluntary and occupational) may see more financial assets accumulated than in the absence of such schemes but again, savers can and do change other aspects of their behaviour in ways that may confound the policymakers' objectives.

A set of acronyms summarises the tax treatment of financial assets, particularly in a retirement saving context. There are three main movements of money:

- **contributions**: 'T' means that contributions to the scheme come from after-tax income; 'E' that contributions reduce *taxable* income before tax is deducted (or attract a direct subsidy); also, in the case of occupational schemes, that the employer's contributions are not deemed part of the employee's taxable pay.
- **investment income on the accumulation**: 'T' means that invested assets are taxed with the saver's other income; 'E' that the assets accumulate tax-free.
- **benefits received**: 'T' means that benefits are taxed as income in the year of receipt; 'E' that benefits are exempt from tax in the recipient's hands.

Most countries treat retirement savings on EET principles – contributions are deductible or directly subsidised through the tax system and, for employees, not deemed to be part of pay (E); there is no tax on the saving scheme's investment income (E) and the final benefits (usually pensions) are taxed as income (T). In an *expenditure tax* environment, EET is relatively neutral[3].

That's because if the government relied entirely on expenditure taxes, taxes are collected when the savings and all other assets are spent. However, in a world where most government revenue is collected from taxes on income, EET is highly favoured[4]. Such a strategy must therefore be designed to encourage greater self-provision for retirement and, impliedly, to reduce pressure on future government-delivered age pensions. That last justification would be part of a stronger case if the state pension were means-tested. Few countries' age pensions are so tested.

On some quite generous assumptions, TTE (and ETT) is a 'neutral' treatment in an *income tax* environment.

A bank account is a convenient example: savings into the account come from after-tax income (T); interest earned on the account is added to the saver's other taxable income (T) while withdrawals from the account are exempt (E). They are not really 'exempt'; they are withdrawals of tax-paid capital.

Countries have different shades of these mixtures and usually run both together. Financial savings that are locked up for retirement may be EET while accessible bank accounts (another potential part of the retirement savings fabric) are TTE. There may also be reduced tax on 'retirement'

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[2] This section was based on my submission for the Retirement Commissioner's 2016 Review: *Ageing populations, retirement incomes and public policy: the four 'first principles' of policy-making - A submission to the Commission for Financial Capability* (accessible here).

[3] They are 'neutral' as long as the marginal tax rates on retirement incomes are equivalent to the rates payable on income during the accumulation period. However, given that retirement incomes are generally lower, average taxes on retirement income will also generally be lower. This means that, even if all withdrawals are taxed under EET (that usually doesn't happen), there is a natural tax bias that favours EET in an expenditure tax environment.

[4] In New Zealand, about 60% of tax revenue was income tax in the 2014/15 year: see *Briefing for the Incoming Minister of Revenue – 2015*, Inland Revenue (accessible here). 40% was through GST and excise duties.

accounts. Australia has 'ttE'[5] which means lower levels of tax than 'normal' on contributions and investment income but, overall, retirement saving schemes are greatly favoured by comparison with, say, bank accounts. On generous assumptions, Australia's ttE is broadly equivalent to the more usual EET.

Of the three money movements, the tax treatment of the investment accumulation is the most significant. This reflects the power of investment earnings (i.e. 'compound interest') over the very long periods involved in retirement saving's accumulation and decumulation periods and the difference between pre- and post-tax returns. Even small differences between pre- and post-tax returns create large differences in the eventual size of the retirement accumulations. Because of the relatively shorter decumulation period in retirement, even if all the benefits were taxed at the retiree's top personal tax rate, the government will never recover the value of the concessions given on contributions to the scheme and investment income earned on the accumulating savings[6]. That makes tax incentives for retirement saving very expensive, especially over the long run[7]. That is not their only difficulty:

- **(a) Tax incentives are regressive:** The rich can afford to contribute more and so capture most of the value of the concessions[8]. Poorer taxpayers, who cannot afford to save, help pay for the cost of the tax concessions ('my tax concession is someone else's tax cost').
- **(b) Regulations are complex:** Savings that attract the concessionary treatment must be kept under EET for decades so the regulations that control the money's entry, accumulation and exit are necessarily intricate[9]. As individuals game the system, the regulations inevitably become more complex and more expensive to administer.
- **(c) Distortionary:** Tax concessions 'label' a particular form of behaviour as preferable to other equivalent behaviour. EET-approved retirement saving schemes are seemingly better for savers than, say, a bank account that retains the TTE treatment. Advocates for tax incentives should show why locked-up savings are better for a country than accessible equivalents[10].

  Tax incentives also distort 'signals'. Fund managers should aim to deliver real returns (more than inflation) to savers. That task is much easier under EET by comparison with an

[5] Ross Guest in *Comparison of the New Zealand and Australian Retirement Income Systems* (2013) accessible here summarises the tax treatment: in Australia, contributions are taxed at a flat rate of 15% to an annual cap of $A25,000. Investment income is taxed at a rate that probably averages 8% and benefits are tax-free if withdrawn after age 60. The lowest individual marginal rate of income tax is 19% after a tax-free band of $A18,200. The tax rules changed from 1 July 2017, including reduced concessions for very high earners and deductibility for employee contributions (see here).

[6] In *How to create a competitive market in pensions: the international lessons* (1998), Institute of Economic Affairs, London, Michael Littlewood explains the mathematics behind this suggestion.

[7] Not many countries count the cost of tax incentives for retirement saving. In 2009, Australia spent almost as much on tax incentives ($A24.6 bn) as it spent on the entire Tier 1 'Age Pension' ($A26.7 bn) – see *The great superannuation tax concession rort* (2009), David Ingles, The Australia Institute (accessible here).

[8] David Ingles (*op cit*) suggests that in Australia, "The current concessions provide almost no benefit to low-income earners." Again: "The system has become so skewed that the annual cost of providing superannuation tax concessions to high-income earners is much greater than the cost of simply paying those same individuals the age pension. Providing tax concessions for superannuation as a mechanism to help insulate the budget from the cost of providing for an ageing population is not sensible." In the US, about 80% of the value of tax concessions is captured by the top 20% of earners; the bottom 60% of earners capture just 7% of that value – see *Tax Deferred Retirement Savings*, Seth Hanlon (2011) Center for American Progress, accessible here. Again in the US, the Congressional Budget Office estimates that the top 20% of households receive nearly twice as much in retirement tax subsidies as the bottom 80 percent combined – see *The Distribution of Major Tax Expenditures in the Individual Income Tax System* (2013), accessible here. The total cost of those subsidies to the US tax system was $US137 billion (0.9% of GDP) in 2013.

[9] 'Protecting' the tax concessions in KiwiSaver is relatively less intricate than applies in most other jurisdictions though there is 'leakage' (first home concessions; disability; death, emigrants).

[10] Some suggest, for example, that "The concessional taxation of superannuation [retirement savings] is…intended to address the bias in the current taxation system against long-term saving." *Submission to the Financial System* Inquiry, The Department of the Treasury, Australia, 3 April 2014 at page 44 (accessible here). This presumes a public policy interest in the relative quality of long-term savings ('better') than short-term savings ('worse'). Expected after-tax returns on savings, from a timing perspective, should be for savers and investors to decide, not governments.

environment where all 'income' is taxed. Coupled with the fact that EET savings are locked-in until retirement, fund managers do not have to work as hard to achieve real returns or to retain existing business.

Also, savers themselves do not capture the full value of EET concessions. Savers can afford to be less sensitive to the fees charged by managers of EET savings compared with their TTE equivalents. That special treatment increases the risks of capture by managers and promoters. Locking EET savings up until retirement increases those risks.

There is also a suggestion of an unintended consequence of New Zealand's TTE regime. Andrew Coleman[11] thinks it may be a cause of New Zealand's runaway house prices. Housing has a more favourable tax treatment than retirement saving so disadvantaging the latter. Because it seems politically difficult to fix the tax treatment of housing it may be preferable to move to the internationally more usual EET for retirement savings. The trouble with this argument is the absence of direct evidence of the linkage, as the author himself acknowledges. There may be a correlation or even a coincidence of timing but, unless a direct link is established, this seems a poor justification for re-introducing the distortions of EET to retirement savings. New Zealand may be the only country to have TTE but is not the only country with significant recent increases in house prices.

(d) Inequitable: As with compulsion at Tier 2, a retirement income policy driven by work-based income necessarily favours higher income earners. This is a separate point from the regressive nature of tax concessions (paragraph (a) above). Those with higher rates of pay increases and more complete working lives tend to save more when saving rates are set in relation to pay. They arrive at retirement with larger retirement accumulations both in money terms and as a proportion of pay. Tax concessions that favour occupational saving schemes tend to institutionalise these inequalities.

(e) Deadweight costs: There are 'deadweight' losses to the economy of collecting the extra taxes needed to finance the more fiscally expensive, front-loaded EET environment. These costs reflect the value of the opportunities that are effectively lost when taxation diverts labour and capital from their best uses.

(f) Loss of flexibility: Next, individuals face costs through a loss of flexibility. Savings might be better spent from a lifetime perspective on an earlier financial crisis (such as a health condition or housing issue) or on a more productive investment, such as buying and building a business or reducing debt. Compulsory private provision at Tier 2 faces parallel difficulties.

(g) Do they work? Given that all countries have tax concessions for retirement saving, we might expect studies that demonstrate the 'value for money' test. Do tax incentives actually increase savings? The answer is 'possibly not' despite very large sums that accumulate in tax-favoured schemes. It's very difficult, perhaps impossible, to work out because we do not know what might have happened in the absence of the incentives; what economists call the 'counter-factual'[12]. Some studies suggest the overall impact on the quantum of savings and national saving rates is doubtful[13].

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[11] *Housing, the 'Great Income Tax Experiment', and the intergenerational consequences of the lease*, Andrew Coleman, 2017 University of Otago Business School, accessible here.

[12] Spain introduced tax incentives for retirement saving in 1988. A report on household behaviour across their introduction concludes that "at most" only one quarter of the contributions were 'new' savings: see *The Effects of the Introduction of Tax Incentives on Retirement Savings* (2007), Juan Ayuso, Juan Jimeno and Ernesto Villanueva, Banco de España (accessible here). That analysis took no account of the cost to the tax system of lost revenue.

[13] Alicia Munnell in *Current taxation of qualified pension plans: has the time come?* (1992) Federal Reserve Bank of Boston (accessible here) suggests that the costs of deferring tax on pension accumulations aren't justified. Instead, the "taxation of benefit accruals should be shifted to a current basis." In *Tax Incentives to Saving and Borrowing* (2003), Tullio Jappelli and Luigi Pistaferri (accessible here) say "…there is considerable empirical debate as to the effectiveness of tax incentives in promoting saving: most studies conclude that tax incentives affect the allocation of household portfolios, but the effect on the amount saved is less clear-cut." In *The Effects of 401(k) Plans on Household Wealth* (2000 – accessible here), Eric Engen and William Gale suggest that, without regard for the fiscal and regulatory costs,

> In fact, if households as a whole were *perfectly* rational, they would allow for the value of tax concessions when setting target retirement saving levels. The annual amounts required to meet a given target are less if those savings are subsidised through favourable tax treatment. We should therefore expect lower annual levels of household saving in a tax-favoured EET environment than under TTE because of the large value of the concessions given by taxpayers to the saver's lifetime saving project. Given that tax breaks seem not to 'improve' the quantum of savings (along with the other difficulties described above), the expensive, complex concessions in an EET environment arguably become pointless.

As a result, while tax policy (or a matching contribution that has similar characteristics to a concession such as KiwiSaver's 'member tax credit') encourages contributions to a retirement saving vehicle (public, occupational or retail), we should expect EET-based incentives to have little, long-term effect on national saving. There have been remarkably few studies as to whether tax breaks work to improve national saving levels and we have offered some international evidence on that issue. Further work is needed both to identify overseas studies and to understand the effect of KiwiSaver subsidies on New Zealanders' recent behaviour.

There is no doubt that the financial services industry favours tax incentives for retirement saving and that alone should give us pause for thought. It is so much easier to generate new business when there is a time-dependent amount paid for by taxpayers.

Given that tax breaks for retirement saving are expensive, complex, inequitable, distortionary, regressive and seemingly don't work, it's difficult to understand why the government might be interested in using tax to increase subsidies to savings. The Minister of Finance in the last government, Steven Joyce answered a reporter's question about that in the 2017 Budget lockup as follows:

> "That's an issue that, from my perspective, would repay further work," Mr Joyce said in the yesterday's pre-budget media and analysts' lockup at the Beehive…
>
> "I literally didn't have time to have a look at it in the current cycle but I'd like to have a look at it in future years – if I get the opportunity."[14]

It might be too much to ask that any review of that issue addresses, let alone answers, any of the problems we have identified with tax breaks for saving but we will suggest the questions anyway.

Questions New Zealand needs to discuss on tax subsidies for saving:

1. Why does our government have a particular interest in the way New Zealanders save for retirement? That 'interest' is currently expressed through KiwiSaver (analysed here in *The Missing 2016 Review*) and through tax breaks given both to KiwiSaver (estimated cost in the 2017 year: $738 m, rising to $840 m by 2019/20) and to the concessionary tax treatment of 'Portfolio Investment Entities' – there is more on that in the next section 4 (Income tax and saving vehicles). Where are the cost/benefit analyses to support these direct, costly interventions in New Zealanders' saving behaviour?

2. Are we correct that tax breaks for retirement saving are complex, distortionary, expensive, regressive and inequitable?

"between 0 and 30 percent of 401(k) balances represent net additions to private savings." If the fiscal and regulatory costs were also included, we think those percentages might turn negative.

[14] From the *National Business Review*, 26 May 2017, accessible here (paywall in place).

3. Are we further correct that tax breaks for retirement saving probably do not 'work' (if by that we mean that they probably do not raise savings overall)? Where is the evidence that costly incentives for KiwiSaver (an accumulated cost to taxpayers of $8.5 billion to date) have increased household savings? In *The Missing 2016* Review, we described what evidence there is on KiwiSaver's impact here[15].

4. If the answers to either question 2 or 3 above are 'yes', can we agree that the government should not try to 'incentivise' people to save particular amounts in a particular way and in particular investment vehicles for a particular purpose?

5. Does the presence of tax incentives increase economic growth above the level that it would have been if they had not been there?

[15] Based on the limited available evidence that was cited in the report, New Zealanders were probably slightly over-saving for retirement before KiwiSaver started in 2007; of KiwiSaver contributions, only about one-third was 'new' savings, the rest being effectively transferred from other financial assets and KiwiSaver members seemed to have accumulated less net wealth than non-members.

4. Income tax and saving vehicles – all 'income' should be taxed at the appropriate marginal rates[16]

The Tax Working Group's 'issues' paper[17] states:

> "If our broad-based, low-rate system is working well, there should be only minor (or no) differences in the tax treatment of different forms of investment." (page 39)

With respect only to the different ways in which ordinary New Zealanders might save for retirement, that is simply not the case.

The following summarises the main issues that New Zealand faces on income tax associated with 'collective investment vehicles' (CIVs):

(a) Different categories of CIV pay different rates of tax;

(b) Different tax regimes apply to different types of asset;

(c) Tax applies to investments differently for CIVs when compared to individual savers.

In 2010, Michael Chamberlain and I reviewed the income tax regime of CIVs and the relationship between 'income' and the income-tested welfare benefits. In essence, nothing has changed so what follows summarises our findings of eight years ago.

Until 2000, New Zealand had a relatively simple tax treatment of CIVs where the CIV's income was taxed at the top personal rate of tax (33%) that was also the corporate tax rate and the rate that applied to trusts. Under the TTE regime (see section 3 – On tax subsidies for saving), members' contributions to CIVs that were workplace superannuation schemes were made out of the employee's after-tax income (the employer's contributions were also taxed at 33%) and withdrawals were treated as tax-paid capital.

An Inland Revenue 2005 *Discussion Document*[18] stated:

> "…it is important that the tax rules for investment income operate efficiently and that investors' decisions are not distorted by different tax treatments for income from investments that are similar in nature……
>
> "The proposals outlined in this discussion document aim to resolve these inconsistencies and the distorting effect they have on investor decision-making."

The results of the review sparked by the *Discussion Document* were the 2007 introduction of Portfolio Investment Entities' (PIEs) and the Fair Dividend Return (FDR) approach to the tax treatment of overseas investments. However, as our 2010 Working Paper concluded, "It is clear that the tax regime is complex and distortionary and this seems at odds with the reasons for the 2007 changes."

There are now, broadly, three types of CIV or pooled investment vehicle:

- A **unit trust** type of product where the return is passed through to the investor and taxable income is taxed at the investor's own marginal tax rate.
- A **superannuation scheme** type of product. These can be a PIE where tax is calculated within the scheme at the investor's Prescribed Investor Rate (PIR) that mimics, on a favoured basis, the investor's marginal rate but doesn't tax all income. Returns are

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[16] This section is based on our Working Paper 2010-1 for the Retirement Policy and Research Centre: *Towards a more rational tax treatment of collective investment vehicles and their investors* (accessible here).

[17] *Future of Tax – submissions background paper* (accessible here).

[18] *Taxation of investment income - The treatment of collective investment vehicles and offshore portfolio investments in shares* (2005) Inland Revenue Department, accessible here.

ultimately distributed to investors as tax-paid capital. A superannuation schemes does not have to be a PIE – in this case, tax is still calculated within the scheme on a 'final basis' but at a standard 28% for the scheme as a whole[19].

- A non-superannuation scheme (which may be a unit trust) that is a **PIE** and that also taxes the income at the investor's PIR.

Separately, the **FDR regime** taxes overseas equities' trusts (and direct equity investments) other than certain Australian shares, on a deemed income basis. Regardless of the investor's actual returns, taxable income is assumed to be 5% of the asset's opening value on 1 April in the tax year for an individual and some CIVs, though most CIVs are now taxed on 5% of the average daily value.

In nearly all cases, the FDR regime will either over-tax or under-tax the investor's actual income, measured against the investor's marginal tax rate and also creates potential liquidity issues as tax is based on deemed income, not income actually received.

Contributions by an employer to a 'workplace superannuation scheme'[20] or a superannuation scheme or a KiwiSaver scheme, are subject to a complex 'Employer Contribution Withholding Tax' (ECWT) if the employer has chosen the multi-rate approach that mimics the employee's marginal tax rate for the last tax year but includes the contributions paid as 'income'. Contributions by employers to other types of schemes are subject to Fringe Benefit Tax.

Different combinations of direct and indirect investment will produce different overall tax consequences.

Overseas investments – ownership basis affects tax treatment

Our 2010 Working Paper analysed the practical implications of the 2007 changes by looking at the different ways a New Zealand saver could invest in overseas shares or bonds. We concluded that:

- For an **overseas share** (we used BHP Billiton as an example of an Australian share), there were at least 11 different ways a New Zealand investor can invest in overseas shares and seven potentially different after-tax returns even though the pre-tax return was the same in each case. However, even the four that had similar tax treatments could vary between themselves (and with others) depending on the relationship between timings of dividends and market values relative to the 1 April fixing of market values under the FDR regime. Even currency management options can affect the optimal tax structure.
- For an **overseas bond**, there are 13 possible ownership choices with 13 potentially different after-tax returns for the same pre-tax return. The 'best' answer for a New Zealand investor will depend on the investor's marginal tax rate, effective marginal tax rate and issues such as costs, convenience etc. For most, owning overseas bonds through a PIE or registered superannuation scheme that invests in an Australian or overseas unit trust that includes currency hedging bought overseas will probably be optimal.

Tax treatment of CIV's income and distributions

The way in which a CIV's income and distributions are taxed also varies by category. Whether returns are 'income' within the CIV depends on the CIV's classification (registered superannuation scheme, unregistered superannuation scheme, unit trust, PIE, 'group investment fund', family trust or even an ordinary bank account).

[19] There is also a trust (such as a family trust) where undistributed income is taxed at 33%, the top personal marginal rate of tax.

[20] 'Workplace saving schemes' are registered under the Financial Markets Conduct Act 2013

Also, the PIE tax calculations for an individual member are complex as the PIR depends on the total of the PIE's income attributable to the member and the member's taxable income in one of the two preceding complete tax years (the lower year). The member must advise the PIE's manager what the correct PIR for each year should be.

Interaction with state benefits

The definition of 'income' matters not just for tax but also for an individual's entitlements to a number of state-provided benefits or obligations that depend in some way on 'income'. These include the Family Tax Credit (FTC), In-work Tax Credit (IWTC), Minimum Family Tax Credit, Parental Tax credit (together referred to as 'Working for Families'), the Independent Earner Tax Credit (IETC), Student Loan payments and allowances, Child Support payments and income-tested welfare benefits such as Sole Parent Support, Job-seeker Support and the Accommodation Supplement.

In all these cases, the 'income' that counts is taxable income[21]. Non-taxable benefits or benefits that are subject to either 'Employer Contribution Withholding Tax' (ECWT) or Fringe Benefit Tax (such as the private use of a car, low interest loan, etc.) are not counted. Neither are the tax credits (FTC, IWTC, IETC etc.).

'Income' within a scheme (and not effectively distributed) is unlikely to be included and that seems illogical.

Summary of the 2007 changes

There is a variety of ways in which assets and income can be 'sheltered' from direct connection with the economic owners of that income. Income derived through the various tax-based vehicles is not always aggregated for either income tax or for the application of income-tested payments.

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 their 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.

As the 2009 Tax Working Group put it:

> "The tax system lacks coherence, integrity and fairness: Differences in tax rates and the treatment of entities provide opportunities to divert income and reduce tax liability. This disparity means investment decisions can be about minimising tax rather than the best business investment. For individuals, the tax burden is disproportionately borne by PAYE taxpayers since many with wealth can restructure their affairs through trusts and companies to shelter income from taxes or to enable people to receive social support."[22]

[21] Though sometimes capital receipts are deemed to be 'income' if they are received on a basis that will be applied for an "income-related purpose": paragraphs (b) and (c) ("whether capital or not"); also paragraph f(xiv)(C) of the definition of 'income' in section 3(1) if the Social Security Act 1964 (accessible here) can include payments from a superannuation scheme.

[22] *A Tax System for New Zealand's Future* (2009) Victoria University Tax Working Group, accessible here, at page 9.

A 'first principles' approach

Our 2010 Working Paper proposed the recognition of a number of key points:

(a) **Principle 1: Tax should not be the driver.**
For an investor in a CIV, it should not matter, from a tax perspective, what that CIV is called or under which legislation that CIV is regulated. In principle, individual investors should be treated similarly for tax purposes in superannuation schemes, PIEs, unit trusts, group investment funds, life insurance funds or companies.

(b) **Principle 2: Place of origin should not matter.**
For New Zealand tax purposes, it should not matter to an individual investor in which country the CIV is resident. Within reason, international CIVs should be treated similarly for New Zealand tax purposes to New Zealand-based CIVs. How the overseas CIV is treated in its local jurisdiction need not affect its New Zealand status when an investor calculates income tax[23].

(c) **Principle 3: The individual's circumstances are important.**
Again within reason, the tax the investor pays on the CIV's return should be close to the normal tax the investor would have paid had the investment been held directly. As the original 2005 *Discussion Document* stated, the investor should choose a CIV for reasons other than tax – for example, for convenience, cost, diversification, liquidity, management skills etc.

These principles may need tempering if the cost of collecting the 'correct' amount of tax were uneconomic. Any replacement compromise should, however, recognise the principles and the costs of change.

The three principles form a suggested 'gold standard' against which any proposals should be measured. The old tax regime that governed the different types of CIV violated all three principles. Regrettably, the current regime is not much better in some respects and is worse in others.

Income should be 'income' and should be taxed and benefit-tested accordingly[24]. The current regime does not come close to that objective.

While the tax treatment of CIVs is normally a compromise between principles and practicality, compromise of principle should apply only if there is a combined effect of simplification and increased net returns to investors with no significant loss of tax revenue. Changes in recent years have failed to achieve these objectives and have left a complex patchwork of compromises and significant discontinuities between the income tax and welfare systems.

CIVs should be encouraged and their continued development should be seen as a contribution to a successful financial services industry. They should not be tax-favoured. The current 'proxy-rate' system of taxing CIV members needs reform. As we said in our 2010 Working Paper:

> "No member of a CIV presently pays the appropriate tax on their full income (both directly and indirectly earned) under New Zealand's progressive tax regime. That distortion is potentially magnified when the tax system is set alongside the income-related aspects of our welfare system…" (page 34)

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[23] The relationship between 'income' earned overseas, any tax paid overseas and the New Zealand tax regime will never be simple, especially where imputation credits are involved. The principle should be that New Zealand taxes the gross income and makes allowance for any tax already paid by the investor.

[24] The personal rates of tax are 10.5% on income to $14,500; 17.5% on income between $14,001 and $48,000; 30% on income between $48,001 and $70,000 and 33% on income over 33%. We think all 'income' whether directly or indirectly received should be taxed at these rates.

We suggested that the combination of income tax, income support and the treatment of CIVs leaves an unsatisfactory gap that now needs to be filled.

It is not possible to distinguish, in policy substance, between:

- income tax (where the state takes money);
- income-support (where the state gives back some of that money in different ways to people it decides need that support) and
- income-testing (where the state takes back part or all of the income support).

Those three strands should go to make up the single environment of defining and calculating 'income'. Only in that context can the significance of CIV-derived income be measured and the problems identified and addressed. The reason that CIVs are adding to the inconsistencies derives from the 'silo approach' to tax policy that has treated some CIVs in isolation[25]. That approach must change.

'Income' for all purposes should be defined consistently, no matter how it has been earned.

Questions New Zealand needs to discuss on income tax issues:

1. Should all CIVs be taxed similarly?
2. Should individuals pay income tax on all their 'income' whether that has been directly received (as with pay or interest income) or indirectly received (as with additions to their account within a CIV)?[26]
3. Should the Inland Revenue be calculating individuals' tax (rather than employers and the managers of CIVs)?
4. Should all 'income' count when calculating income-tested welfare benefits?
5. If a CIV investor is tax-exempt (such as a charity) should any tax paid by a CIV be fully recoverable?
6. If the CIV investor has accumulated tax losses from earlier years or from the current year, should any CIV income be offset against such losses?
7. If an overseas CIV has paid any tax that can be attributable to an individual investor, should that tax be offset against any New Zealand tax liability on the same attributable income?
8. Rather than trying to define income exhaustively, should the Income Tax Act 2007 state some broad principles, specifying a list of considerations that the Commissioner of Inland Revenue should take into account when deciding what is 'income' and what is not?

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[25] The 'silo' approach to the tax treatment of 'income' was probably born of the Inland Revenue's administration systems. The Inland Revenue effectively contracted-out the calculation of tax to PIEs and superannuation schemes as it could not cope with doing those calculations itself. We think that the Inland Revenue should be calculating tax, not each employer or manager of a collective investment vehicle. Only the Inland Revenue has all the information that is needed to calculate the correct amount of tax for an individual taxpayer under our progressive tax framework.

[26] Tax can still be calculated and paid by the CIV but as a down-payment on the saver's final liability, in a manner similar to the imputation credits that can be added to a company's dividend.

9. Should the principles of 'binding rulings'[27] be expanded to include a formal system of 'practice notes' that will give greater certainty of tax consequences and increased flexibility than the current court-based system?

[27] See here for more on 'binding rulings'.