pensioncommentary

THE UNIVERSITY OF AUCKLAND BUSINESS SCHOOL

An article from the Retirement Policy and Research Centre

Tax changes: Tax reform fails to meet original aim

When the government set out to reform the tax treatment of pooled saving products (like superannuation schemes) and international shares, one of the reasons for change was to even out the tax playing fields; to reduce or even remove tax as a reason for investing in a particular way. Here is what the 2005 *Discussion Document* [1] said:

> "… 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."

Now that we know the results of all the recent changes to the superannuation environment, what have we ended up with? A bit of a mess actually, compounded by last minute, undebated changes to the KiwiSaver regime.

Here in summary is where we have we got to:

Definition of investment income

We now have three different ways of calculating a superannuation scheme's investment income, depending on the type of asset:

- Income from cash or bonds is under the accruals regime – that hasn't changed.
- For NZ and some Australian shares, the answer will depend whether the scheme is a PIE (see below) – if it is, only dividends (not trading gains) are taxable income. For non-PIEs, the answer will depend on whether the scheme is holding the investment on capital account or is a "trader".
- For all other overseas shares (both PIEs and non-PIEs), the scheme's income is based on the so-called "fair dividend rate" – it's an artificial concept that uses 5% of the year's opening value for each share, regardless of what actually happens to the share price and dividend during the year.

The "income" from directly owned property hasn't changed.

Tax treatment of investment income

How the scheme's investment income is then taxed depends on what type of tax beast it is – a "portfolio investment entity" (PIE) has to know whether a member is a 19.5% taxpayer. That depends on how much taxable income the member earned in the previous year. If earned income is less than $38,000 and total income (including PIE income) is under $60,000, the PIE income is taxed at only 19.5%. So, if a member's income comes only from PIEs, the member can have up to $60,000 a year ($120,000 for a couple – an "all or nothing" test) taxed at only 19.5%. For everyone else, including members of non-PIEs, the scheme pays tax at 33% (the maximum rate, regardless of the member's marginal rate – 33% or 39%).

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[1] *Taxation of investment income - The treatment of collective investment vehicles and offshore portfolio investments in shares - A government discussion document*, Policy Advice Division of the Inland Revenue Department.

Tax treatment of contributions
The contributions **by a member** come from after-tax income on which the member has paid tax at 15%, 21%, 33 or 39% (plus an ACC levy). That hasn't changed.

Contributions **by employers** are now complicated. If they are made to a KiwiSaver scheme or to a KiwiSaver 'look alike' called a "complying fund", they are tax-free as long as they are no higher than 4% of the member's pay (or what the member contributes, if lower). If they are made to a non-KiwiSaver scheme, they are subject to either a straight 33% withholding tax (regardless of the member's income) or a variable 15%, 21% or 33% depending on the income the member earns in the current year (new employees) or in the last financial year (others). However, there is an allowance of 20% on top of the normal tax bands before the next higher tax rate kicks in, just to make it a bit more complicated.

As before, "salary sacrifice" lets employees turn pay into employer contributions to take advantage of a usually reduced tax on those contributions under the withholding tax regime (potentially nil in the KiwiSaver case).

And then there are the government's own contributions to KiwiSaver schemes – the initial $1,000; the on-going administration fee subsidy and the subsidy for first-home buyers (up to $5,000 after five years). They are all tax-free.

Tax on benefits
Benefits from superannuation schemes remain tax-free. They are still treated as withdrawals of tax-paid capital, even when tax subsidies have applied.

"Investor's decision-making"
In the face of the government's original objectives, the tax playing field has now been tilted in favour of investing, and being paid, through a superannuation scheme. Despite what the *Discussion Document* said, investors' decisions will be distorted by different tax treatments for income from investments that are similar in nature. In summary:

- Employees should receive pay through superannuation (particularly KiwiSaver), rather than as taxable wages. That's not just because of tax breaks and the so-called "sweeteners". Superannuation contributions by "salary sacrifice" also reduce the employee's income that counts for various income-related payments such as Working for Family Tax Credits and repayments of Student Loans; they may also reduce the employee's liabilities for Child Support.
- Everyone should receive investment income through a scheme, particularly if it is a PIE, rather than directly. The only exception will be someone who paid less than $50,000 for directly invested overseas shares ($100,000 for a couple). For them, the new regime treats directly owned shares more favourably. Anything above the $50,000 threshold - an 'all or nothing' test – should be held through a superannuation scheme.

The new PIE rules also require a complete upheaval to superannuation scheme administration systems and the way they allocate income to members. However, even a small, 'closely held' scheme can invest in a PIE and allow the individual to capture directly the PIE advantage and limit tax on the rest. The separate scheme doesn't itself have to be a PIE – yet another complexity in the PIE landscape.

The *ad hoc* decisions fail the tests the government set itself in the 2005 *Discussion Document*. The discontinuities between different parts of the overall superannuation environment, the illogical tax treatment of contributions and investment income and the artificial distinctions between directly and indirectly earned income mean, inevitably, that the new rules will be subject to constant 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 breaks 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, we have lost the natural meaning of "income". In our progressive tax regime, how much total "income" you receive matters to the system's integrity. "Investment income" potentially now need have no clear connection with the member's economic capacity to pay tax. It would be nice to report that principles had been set aside for practical considerations. Regrettably, that isn't the case.

Someone needs to take a step back and question what we have achieved. That sense test was missed with the mess we have ended up with.

So, what should have happened? There is an alternative that we will describe in our next PensionCommentary.

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