pensionbriefing

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Superannuation schemes, tax and "income"

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Introduction

This *PensionBriefing* describes the different types of superannuation schemes that New Zealand now has and also the different definitions of "income" that may affect income tax and the interaction between individuals and the welfare system. It draws on and updates *PensionBriefing 06/2007.*

In recent years, tax changes marked the demise of the pure comprehensive income tax approach that had been the hall-mark of New Zealand's retirement savings policies for nearly 20 years. Their introduction significantly complicates decisions for employers, employees and other savers, with implications for an erosion of the tax base. Given their complexity, this *PensionBriefing* sets out the factual aspects of these changes.

The current environment

To understand the complexity of the current environment, Appendix 1 gives a brief description of the nine regulatory definitions of what is regarded as a 'superannuation scheme'. Appendix 2 lists five regulatory definitions of 'pay' and a brief description of their interactions with tax and the state benefit arrangements. For ease of reference, the defined expressions are used in the *PensionBriefing* with capital initial letters.

In the context of those regulatory interventions in the decision-making process, the following describes the different issues that an employee may take into account.

1. "Salary sacrifice"

If an employee agrees not to receive part of the employee's remuneration as taxable pay in exchange for a contribution by the employer to a superannuation scheme ('salary sacrifice'), tax savings may arise as follows:

1.1 To a KiwiSaver Scheme: The "employer superannuation contribution tax" (ESCT) is nil on the employer's contribution up to 2% of the employee's gross taxable income, or up to the employee's own contributions when they are less than 2%. Normal ESCT rates applicable to the employee, of 12.5% 21% or 33% apply to any excess over either of those amounts. Fund Withdrawal Tax (see below) can potentially apply to contributions to which ESCT applied[1]

1.2 To a Complying Fund: a similar KiwiSaver Scheme treatment applies to salary that is sacrificed to a Registered Superannuation Scheme that has been approved

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[1] But will have limited practical effect, given that KiwiSaver benefits are locked up until age 65 in most cases. KiwiSaver schemes will not therefore be used to cycle significant amounts of salary except, perhaps in the years immediately before retirement.

by the Government Actuary as a Complying Fund. However, the KiwiSaver 'kick start' of $1,000 does not apply.

1.3 To another Registered Superannuation Scheme: The highest rate of ESCT is 33% so that if an employee's income together with the employer's contribution would have indicated a marginal tax rate of 38%, contributions are tax-advantaged.

1.4 To a separate unregistered scheme: These are referred to in the Income Tax Act 2004 as "Superannuation Schemes" and may have a place in financial planning. While a Fringe Benefit Tax of 49% (or 61%) that is deductible to the employer applies to these contributions, (which is equivalent to 33% or 38%, as the case may be, non-deductible) such contributions are not aggregated with other income for purposes of determining any ESCT on contributions to any other registered scheme. Nor is any Fund Withdrawal Tax (see below) payable on benefits withdrawn. Salary sacrifice to an unregistered scheme, while not actually saving tax by comparison with PAYE Earnings, can reduce what counts as "income" for a number of purposes without overly affecting flexibility.

As explained in Appendix 2, the appropriate ESCT rate is based on the combined amount of 'taxable pay + employer contributions' in respect of the member in the last complete financial year. If the employee has not worked for the employer for a complete year, the total is based on the employer's estimate for the current financial year.

However, the tax thresholds for normal income tax ($14,000 and $48,000) are increased by 20% (to $16,800 and $57,600) before the next higher tax bracket applies for ESCT. This is an all or nothing test – if the total passes a threshold by only $1, the higher rate applies to all the employer's contributions.

The top rate of ESCT is 33% so that applies to all sacrificed income if the total taxable pay exceeds $57,600 in a year.

Salary sacrifice will also reduce employee and employer ACC levies. But benefits such as ACC and other pay-related benefits (such as death cover or superannuation entitlements) may be reduced as they are based on taxable pay after the sacrifice. An employer that introduces salary sacrifice can avoid this consequence by re-defining 'pay' for those other employee benefits to include the amount sacrificed. That will not, however, affect the ACC-related liability (and benefit) that remains tied to PAYE Earnings.

2. "Fund Withdrawal Tax" (FWT)

To limit taxpayers' ability to cycle pay through superannuation schemes, FWT charges 5% on withdrawals that are not 'proper' superannuation benefits. However, FWT does not apply in some cases but, confusingly, can apply at "normal retirement"[2]. FWT applies to Registered Superannuation Schemes, but not, in due course, to KiwiSaver Schemes (see the explanation of the FWT calculation in Appendix 2).

However, FWT can even apply to 'real' employer subsidies as opposed to re-arranged remuneration that is the subject of this *PensionBriefing*. However, if the sum of employee's

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[2] FWT is a complex tax with a number of quite detailed exemptions. One such is for "early retirement" as long as that complies with certain rules. There is no exemption for a full retirement at, say, age 65. This is a clear gap in the legislation. Regrettably, it is only the most obvious gap.

"taxable income" (note, not PAYE Earnings) and employer contributions is less than $70,000 in each of the four years preceding a benefit payment, no FWT is payable[3].

3. KiwiSaver Schemes

An employee who joins a KiwiSaver Scheme qualifies for a number of incentives, each of which improves the net value of the employee's remuneration. In summary:

3.1 "Kick start": The government will contribute $1,000 tax-free after three months' membership.

3.2 "Tax credit: If the employee contributes at least $1,042.86 a year (equivalent to $20 a week), the government will contribute a matching amount. Again, that is tax-free and is paid as a lump sum direct to the employee's KiwiSaver Scheme after the end of the government's financial year (30 June).

3.3 Employer's contributions: Employers must contribute to KiwiSaver for employees who belong to a KiwiSaver Scheme and who are contributing. The required contributions are 2% of the employee's PAYE Earnings (but if the employee is contributing less, the employer need not do more than match the employee's contributions). The contributions are not subject to ESCT and are therefore tax-free.

Whether the employer's contribution directly rewards an employee depends on the employer's remuneration strategy. The employer's contribution can, with the employee's agreement, be treated as part of pay rather than as an additional amount the employer has to pay on top of regular remuneration[4].

3.4 First home subsidy: Under certain conditions a first home buyer[5] may qualify for a government subsidy of $1,000 a year for up to five years' membership.

4. PIE income

The Portfolio Investment Entity ("PIE") rules are designed to ensure that investment income attributed to a member is taxed at a rate that reflects the member's overall taxable income.

If a member earns only PIE income then tax on the PIE's investment income that is attributable to the member is 19.5% as long as the PIE income does not exceed $60,000 a year before tax.

If the member has taxable income then, as long as that does not exceed $38,000 the member can have combined pay + PIE income of up to $60,000 in a tax year and still effectively pay only 19.5% on the PIE income component[6]. The test is based on combined income in either of the two previous financial years. It is sufficient if the test is satisfied in one of those years.

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[3] Section CS1 Income Tax Act 2004.

[4] In a pure "total remuneration" environment, any amounts the employer is required to pay as a result of the employee's decision to join a KiwiSaver Scheme can be taken into account in setting the remaining pay. Employers may alternatively choose to reward those in KiwiSaver with contributions that are in addition to gross pay.

[5] There are household income and house price restrictions that aim the subsidy at 'average' earners buying cheaper houses as a 'principal residence'.

[6] The PIE itself pays the tax as a proxy for the member who receives a credit of the net amount within the PIE's accounts.

However, if the member receives $1 more than $38,000 in taxable pay or $1 more than a combined $60,000 of pay + PIE attributed income, then the whole of the PIE income in respect of the member is taxed at the alternative higher PIE rate. From 1 April 2008, the top PIE rate reduced from 33% to 30% but the lower rate remains 19.5%[7].

Both rates result in investment income being taxed at a lower rate in a PIE than would have applied had the income been earned directly by the member.

The PIE tax rate that applies in respect of a member of either 19.5% or 30% is called the "Prescribed Investor Rate" ('PIR').

The employee's decisions

Faced with the above, what avenues are open to the employee to maximise their gains from the new regime, assuming the employer is prepared to co-operate?

Ignoring, for a moment what the employee might need to live on, the employee could maximise the after-tax (and ACC levy) value of the remuneration package by first lowering PAYE Earnings to as little as $38,000 a year. Fixing taxable pay in this way will allow the employee to step into the favourable PIE regime, as long as the employee's other taxable income (including PIE income) does not exceed $22,000.

The decisions the employee must make include:

- salary sacrifice to a Registered Superannuation Scheme;
- joining KiwiSaver;
- salary sacrifice to an unregistered Superannuation Scheme;
- maximising the concessions available under a PIE.

These are not straightforward issues and employees may feel they need to take advice.

The PIE influence

The PIE advantage is as follows - once the employee has been on 'after salary sacrifice' basis with PAYE earnings and other taxable income of no more than $38,000 for at least one complete tax year, up to $22,000 of investment income ($60,000 less the taxable pay of $38,000) can be earned through a PIE with tax at only 19.5%. Had that been added to other taxable pay, it would have been at 33%

The value of that will depend on the employee's PIE position (how much money is invested in PIEs) but could be worth as much as $2,970 a year ($22,000 * (33%-19.5%)). The employee's spouse/partner can also be joined in to increase the advantage of the PIE income concession to the household.

Interaction with state-provided benefits

There are several other influences that may affect the employee's decision. Most income-tested state benefits are affected by PAYE Earnings as that is defined in Appendix 2. This applies for example to:

- Working For Families Tax Credit;
- Independent Earner Tax Credit;

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[7] The government has announced that, from 1 April 2010, the PIE rates will be 12.5%, 21%, 33% and 30%. There were no details in the announcement as to how that will happen.

- student loan payments;
- child support payments
- ACC levies and
- ACC income-related benefits.

It also affects an employee's (and employer's) obligations to contribute to a KiwiSaver Scheme.

A decision to sacrifice salary can therefore have a positive effect on a family's net spendable income, depending on its potential entitlements under these different programmes.

Conclusion

New Zealand has moved away from a comprehensive definition of "income" from employment. That change also has significant implications for state benefits where some form of test of "income" affects entitlements and/or obligations. The fact that individuals more frequently have more than one employer also complicates the administration of both tax and welfare benefits, and their interaction.

As the boundaries between different kinds of rewards for work become less clear, there will probably be a growing role for tax planners and remuneration advisers who will be needed to help employers and employees through the different rules. There will also be more changes as the boundaries are tested. The latest proposal from the government to change the tax bands for PIEs[8] is the most recent example of that. Few details are available but working out who qualifies for each of these lower rates will add further complexity and possible threats of clawbacks if the calculations are wrong.

[8] Announced on 7 July 2009.

Appendix 1

The nine different types of superannuation schemes

New Zealand now has nines types of superannuation schemes from a regulatory viewpoint.

1. **Registered Superannuation Scheme**

   This is registered by the Government Actuary under the Superannuation Schemes Act 1989 with minimum requirements for registration, reporting and administration. The Government Actuary provides regulatory oversight. The Income Tax Act 2004 calls this a "superannuation fund".

2. **Superannuation Scheme**

   Under the Income Tax Act 2004, a superannuation plan that isn't a Registered Superannuation Scheme is called, confusingly, a "superannuation scheme". Employer's contributions are subject to the FBT regime.

3. **KiwiSaver Scheme**

   A KiwiSaver Scheme is approved under the KiwiSaver Act 2006 and is not a Registered Superannuation Scheme. It receives KiwiSaver contributions from members and their employers. Benefits are generally locked up until age 65. The government subsidises the scheme with "sweeteners" and tax concessions.

4. **Chosen KiwiSaver Scheme**

   A KiwiSaver Scheme may also be a **Chosen** KiwiSaver Scheme. An employer can identify a particular KiwiSaver Scheme as the one its employees will join, by default, if the employee does not choose a scheme directly.

5. **Default KiwiSaver Scheme**

   A KiwiSaver Scheme may also be a government- designated **Default** KiwiSaver Scheme. If an employee does not choose a KiwiSaver Scheme **and** if there is no **Chosen** KiwiSaver Scheme, the IRD randomly allocates the employee to a Default KiwiSaver Scheme. A default scheme can also be a Chosen KiwiSaver Scheme.

6. **Exempt Scheme**

   The more accurate description is a Registered Superannuation Scheme that lets an employer be an "exempt employer"; that is, exempt from the automatic enrolment of new employees into a KiwiSaver Scheme. An Exempt Scheme requires at least 2% of pay as contributions in respect of members. It can be part of a wider scheme that qualifies under 1. above. Benefits do not have to be locked up until age 65 but there are no government incentives.

7. **Complying Superannuation Fund**

   If an employer wants to contribute to a separate scheme (1. above) and qualify for the same tax concessions as noted in 3. above, it can ask for a scheme (that existed on 1 July 2007) or a section of a scheme to be classified as a Complying Superannuation Fund. Contributions and benefit provisions parallel those of a KiwiSaver Scheme. A "complying" fund can be part of a wider scheme that qualifies under 1. above.

8. **Existing Superannuation Scheme**

   If an employer contributes to a Registered Superannuation Scheme (1. above) that existed on 17 May 2007 for members who joined before 31 March 2008 (or have the right to join), the employer does not have to contribute to KiwiSaver for them as long as the KiwiSaver minimum is paid.

9. **Retirement Savings Scheme**

   Section NEB5 of the Income Tax Act 2004 regulates a "Retirement Savings Scheme" (RSS), established at the instigation of Te Runanga o Ngai Tahu (TRoNT). This imposes "retirement scheme contribution withholding tax" (RSCWT) that is the same as the member's normal marginal tax rate (19.5%, 33% or 39%). The RSS must be a PIE and the investment income will not affect income-tested state benefits. Benefits are subject to similar rules as apply to Complying Funds (7 above).

Appendix 2

What is "income"?

The rules that affect contributions to superannuation schemes (and investment income from them) have increased the number of regulatory definitions of "earnings" and the tax and state benefit consequences that follow. Here are the main definitions that an employer might encounter.

(a) 'Earnings' for income tax

The 'pay' for ordinary income tax is direct cash remuneration, including bonuses, overtime and allowances - we'll call this "PAYE Earnings". The 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: ACC premiums for both employee and employer are based on PAYE Earnings. The permanent disability ACC pension is also based on this. Details are as at 1 April 2009.

If the employee receives non-cash benefits (like a car, low interest loan, subsidised or free accommodation) the value of that is added to direct cash remuneration for the calculation of Fringe Benefit Tax (FBT). The grossed up equivalent of the tax that would have been paid by the employee is payable by the employer (plus GST, where applicable). The employee pays no tax directly as it is not income earned directly by the employee.

(b) 'Earnings' for ESCT

The 'earnings' that drive the calculation of Employer Superannuation Contribution Tax (ESCT) is the total of PAYE Earnings and contributions paid by the employer to Registered Superannuation Schemes in respect of the employee, including employer contributions to KiwiSaver that exceed the tax-free limit – we'll call this the "Total of Relevant Amounts".

It does not include employer contributions to what the Income Tax Act calls a "Superannuation Scheme"[9]. Those are subject to FBT.

[9] The Income Tax Act 2004 confusingly calls a scheme that is registered under the Superannuation Schemes Act a "superannuation fund" while an unregistered scheme is called a "superannuation scheme".

The ESCT rate is as follows:

Total of Relevant Amounts	ESCT rate
	- for normal scheme
0 to $16,800	12.5%
$16,801 to $57,600	21%
$57,601 and over	33%
	- for KiwiSaver
(a) For up to 2% PAYE Earnings (or employee contributions if lower)	0%
(b) On the excess	As above

Note: an alternative ESCT rate is 33% on all affected contributions. In all cases, the rates are applied to the gross contribution. The net value is the amount actually received by the scheme.

ESCT is not cumulative, as with income tax. If the employer's contributions mean that the Total of Relevant Amounts is $57,601, ESCT becomes 33% of all employer contributions, including for the contributions included in the Total Relevant Earnings that are below $57,601. However for KiwiSaver on its own, the exemption is allowed to the maximum with only the excess taxed as for other employer contributions.

(c) 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 PAYE Earnings;

(ii) other taxable income received by the member (interest, dividends, other employment);

(iii) PIE income in that year.

We'll call this 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, like ESCT, an 'all or nothing' test. If either the PIE Total exceeds $60,000 or the total of the member's PAYE Earnings and other taxable income exceeds $38,000 in that year, the PIE tax rate must be 30%. Earnings must be less than both for the lower 19.5% rate to apply.

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.[10]

(d) For calculating Fund Withdrawal Tax (FWT)

FWT of 5% is due on the payment by an employer-sponsored Registered Superannuation Scheme. The rules for this are complex and there are exemptions but the 'pay' that triggers the potential liability is as follows:

> PAYE Earnings (as above) and other taxable income **plus** all the employer's contributions paid to any Registered Superannuation Scheme by any of the member's current employers (and also including previous employers) in the current year and during the four preceding financial years. Let's call this the "FWT Total".

The 'contributions' for this purpose do not include the employer's contributions to a KiwiSaver Scheme, including those in excess of the compulsory 2% of PAYE earnings as a "permitted withdrawal from a KiwiSaver scheme or a complying superannuation fund" is exempt[11]. That also applies to an employer's contributions to an unregistered "superannuation scheme" as they have been subject to the FBT regime for contributions.

If the FWT Total is less than $70,000 in each of the four years, no FWT is payable. The potential FWT liability is reduced by 25% for each complete year the FWT Total is less than $70,000.

(e) Interaction with state benefits

The entitlements to a number of state-provided benefits or obligations depend in some way on "income". These include:

(i) Working For Families Tax Credit;

(ii) Independent Earner Tax Credit;

(iii) Student Loan payments;

(iv) Child support and maintenance payments;

(v) ACC levies

(vi) ACC's income-related benefits.

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[10] 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 be implemented.

[11] Section CS 10B of the Income Tax Act 2004.

In each of these cases, it is the earner's PAYE Earnings that count. This Briefing Paper has demonstrated that there is considerable potential to manipulate PAYE Earnings and, therefore, their impact on all of the above items.

Using salary sacrifice to an unregistered "Superannuation Scheme" also has the same effect. Even though it will not reduce overall tax (PAYE tax + FBT), it will reduce PAYE Earnings.

(f) For calculating holiday pay

"Ordinary weekly pay" under the Holidays Act 2003 includes:

(i) pay for an "ordinary working week";
(ii) bonuses but only if they are a regular part of pay;
(iii) overtime payments if those are a regular part of pay;
(iv) the "cash value of any board or lodgings provided by the employer".

Irregular and discretionary payments are not included in calculating pay for ordinary holidays so the amount will often be less than PAYE Earnings.

However, for public holidays "relevant daily pay" means, broadly, the pay the employee would have received on the public holiday concerned, including what might have been irregular payments that might have been excluded for ordinary holidays.