pensionbriefing

THE UNIVERSITY OF AUCKLAND BUSINESS SCHOOL

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Structuring remuneration to maximise value through 'salary sacrifice'

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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[1]	$1,810
Net income	$101,640

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	$1,190	$52,660
Less KiwiSaver employee contribution		$1,400
Take home pay		$51,260

[1] 1.7% on taxable pay up to $106,473 a year.

2. KiwiSaver contributions

Employee	$1,400 (from after-tax income, as above)
Employer	$1,400 (tax free)
Plus government subsidy	$1,043 ("member tax credit", tax free)
Total to KiwiSaver	$3,843

3. Other superannuation

Before tax	$78,600	
Less ESCT	$25,938	$52,662

Total net value of package **$107,765**[2]

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?

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[2] 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.

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)[3]. 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.

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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[3] 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.