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A comment on investment income, tax, welfare benefits and the 2010 Budget

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This *PensionBriefing* updates the conclusions of an RPRC Working Paper 2010-1 on the tax treatment of collective investment vehicles and their relationship between personal incomes and state-provided welfare benefits. This is in the context of the 2010 Budget.

In summary

The 2010 Budget changed some aspects of the tax treatment of investment income but its focus on rationalising the top tax rates and on property investment means there is more work to be done if overall equity is to be restored to the tax and benefit systems. The Social Assistance (Future Focus) Bill, also introduced in May 2010, proposes changes to the detail of the income-testing arrangements that will apply to benefits. However, the structure of the current basis will remain.

Background

In March 2010, the Retirement Policy and Research Centre published a Working Paper, *Towards a more rational tax treatment of collective investment vehicles and their investors* (Chamberlain & Littlewood, 2010) that details the problems with the tax treatment of 'collective investment vehicles' (CIVs). The report describes the inconsistent and illogical ways in which 'income' is defined and taxed. It also suggests a way in which these difficulties can be resolved.

The report concludes that current problems arise because the tax system has been designed in regulatory 'silos', where each part of the system has little connection with others, and the whole has only minor links with state-provided, income-tested payments. For example, income-tested state payments, like Working for Families, ignore income that is indirectly received. The report suggests that the whole framework needs review and reform.

The treatment of different CIVs can affect the way employees are paid (through a mix of direct pay, PIEs that are both KiwiSaver and non-KiwiSaver schemes, non-PIE registered superannuation schemes and even unregistered schemes) and how they earn their investment income through a different mix of those CIVs. For tax purposes alone, there are still four different types of superannuation scheme. Tax planners may welcome such diversity but, over the years, the report suggests that New Zealand has been taking backward steps as far as tax equity is concerned.

The RPRC's report suggests that:

- The 2007 tax reforms to CIVs failed their key objective – to reduce the influence of tax in investment decisions. It matters for tax purposes how savers make their investments.

- New Zealand needs a full discussion on levelling the tax playing field, both between different CIVs and then between CIVs and investors, while at the same time reducing the regulatory costs of intermediation.
- The present tax regime in New Zealand is now inconsistent, complex and unfair. It can and should be changed.

The key recommendation of the report is that, in a fair and equitable tax system, all 'income' is taxed at the individual's appropriate marginal tax rate. If state entitlements depend on 'income', all income counts, no matter how it is received, and whether or not that 'income' is paid directly to the recipient of the state–provided payment. The RPRC's report concluded that none of these things happens now.

Changes in the 2010 Budget

The main changes announced in the 2010 Budget, relevant to the taxation of CIVs, were:

- The top personal tax rate was reduced from 38% to 33%, the same rate as applies to trusts, including 'family trusts'.
- The dollar amounts of the personal tax bands were not changed but the tax rates were reduced from 38% to 33%; from 33% to 30%; from 21% to 17.5%; and from 12.5% to 10.5%.

  Corresponding changes will be made to the 'prescribed investor rates' (PIRs) for 'portfolio investment entities' (PIEs); also to Employer Superannuation Contribution Tax (ESCT) rates.
- The tax rate for companies, and CIVs – that is, 'group investment funds' (GIFs), PIEs, unit trusts and superannuation schemes – will be reduced from 30% to 28%.

The previous problems

The RPRC's March 2010 report identified the following key features of the treatment of 'income' for tax and welfare benefit purposes:

(a) **Final taxpayers:** CIVs are sometimes 'final' taxpayers in that the income they receive in respect of investors is taxed within the CIV but is not further attributable to the investor and no further tax is payable. Examples of CIVs that are final taxpayers include family trusts, PIEs and superannuation schemes.

(b) **Interim taxpayers:** However, for other CIVs (such as bank accounts, companies and unit trusts), tax is payable by the CIV effectively on the investor's behalf. It is then attributed to the investor who includes both the gross income and the tax deducted at source. The final tax payable by the investor reflects the investor's personal liability, based on total income. In the cases of unit trusts and companies, this process is called 'imputation'.

(c) **Welfare connections:** income received by investors from CIVs that are final taxpayers does not count as 'income' when income-tested welfare (and other) state provided benefits are calculated. However, income received from CIVs that *are* interim taxpayers is included. In these cases, the taxpayer's "Effective Marginal Tax Rate" (EMTR), where they are subject to abatement, will be somewhat higher than their marginal tax rate.

(d) **Complexity:** a PIE (a CIV that is a final taxpayer) has complex rules so that the "prescribed investor rates" (PIRs) bear some relationship to the investor's marginal rate. However, the association cannot be close, especially when the marginal tax rate of the investor on directly earned income moves to the next

higher rate. An artificial 'buffer' is added to the tax band but the 'all or nothing' basis on which the PIR is applied inevitably creates anomalies (both over- and under-taxation of the PIE-derived income).

(e) **Overseas investments:** There is another complex set of rules that govern the tax treatment of the ultimate, overseas-domiciled investments themselves:

   i. Australasian shares owned by a PIE do not face tax on trading gains, even if they were bought with the intention of re-selling for profit.

   ii. Bonds are taxed under the accruals regime where 'income' includes changes in the capital value attributable to changes in interest rates.

   iii. All other overseas investments are taxed under the Fair Dividend Return (FDR) regime that deems the income for the year to be 5% of the investment's market value at the start of the year, regardless of the return that is actually earned – even if that is actually a loss.

The treatment of bonds is the same for local investments but the other two bear no relationship to the way these investments would be treated if they were domiciled in New Zealand.

Summarising points (a) to (d) above, the RPRC's 2010 report concluded that the treatment of income for tax purposes and the net economic benefit to the investor after allowing for income-tested welfare (and other benefits), depends on:

- Whether the investment is made directly or indirectly, through a CIV;
- The type of CIV used;
- Where the CIV is domiciled for tax purposes;
- Where the investment itself is domiciled.

The report illustrates that, with respect to a single Australian share, there are 11 different ways a New Zealand taxpayer could own the share with potentially different tax consequences. For an overseas bond, there are 13 different possibilities. For this reason, the report warns:

> "It is clear that the tax regime is complex and distortionary and this seems at odds with the reasons for the 2007 changes. This can only be a general explanation and should not be construed as tax advice. It is now very important for investors to check with a tax expert before making any investment decision. That need also illustrates what is wrong with the current environment." (Chamberlain & Littlewood, 2010, p. 14)

The Budget in more detail

With respect to income tax rates, much of the pre-and post-Budget commentary focussed on the differences between the top personal rate (38%) and the tax rates that applied to family trusts (33%) and companies (30%). Higher income earners could effectively reduce their tax by shifting investments from direct to indirect ownership. Also, owners of property investments could generate tax losses that potentially improved entitlements to income-tested state benefits.

The 2010 Budget has changed some of the earlier tax landscape. From an income tax perspective, there will now be no difference between income earned from directly held investments at the top personal tax rate (33%) and income earned within a family trust (also now 33%). However:

- **Company and family trust:** The gap between the company tax rate and the family trust rate has increased to 5% (28% and 33%) from 3% (30% and 33%).

- **Company and top rate:** The gap between the company tax rate and the top personal rate remains, although it has been reduced. It was 8% (30% and 38%) and is now 5% (28% and 33%).
- **CIV and top rate:** The gap between the top personal rate and the CIV rate (such as for superannuation schemes) has also reduced from 8% (38% and 30%) to 5% (28% and 33%). Investment income earned through a CIV is still taxed less than income directly received.

From equity and simplicity perspectives, there are no grounds to justify these remaining differences and New Zealand should eliminate them. Individuals whose earnings attract the top personal tax rate should not have the option of choosing a vehicle through which to earn investment income that will incur a lower tax rate.

Although the Budget has removed depreciation on buildings as a way of reducing otherwise taxable income, it has left untouched the more effective and flexible way of 'hiding' income through CIVs that are final taxpayers[1].

As the RPRC's March report explained, the differences in the top tax rates were only part of the problem. The following additional areas of concern have yet to be addressed:

(a) CIVs that are final taxpayers:

It seems at best anomalous that investors can manipulate their tax rates (and their EMTRs – see below) by choosing a CIV that is a final taxpayer. For example, by splitting investment income between a PIE and a superannuation scheme, even those with very significant 'economic incomes' can preserve a PIE's concessionary tax treatment.[2]

(b) Some anomalies:

In some cases, for example with a superannuation scheme, there is a tax penalty in using a non-PIE CIV that is a final taxpayer. An investor with a marginal tax rate of 10.5% (now, incomes to $14,000 in a year) or 17.5% (now, $14,001 to $48,000 in a year) will pay more tax under non-PIEs i.e. 28%.

There is also a substantial difference between the trust rate of, still, 33% and the new lowest personal rates of 10.5% and 17.5%, so the trust should distribute beneficiary income as before.

Neither of these applies to CIVs that are not final taxpayers such as companies that pay dividends and bank accounts. As before, the distributed income will eventually be taxed at the appropriate rate once the taxpayer's total income for the year is known.

With a PIE, there is unlikely to be any tax disadvantage because of the margins built into the calculation of the new PIRs. However, that could change where there is a significant fall in income in an income tax year (for example, following unemployment or retirement). Because PIRs are based on previous tax years, they could be higher than would be appropriate for the lower later income.

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[1] It also left untouched the issue of a tax on capital gains as recommended by the Tax Working Group.

[2] We suggest this concept is important in the current context because it describes the total change in a household's economic position regardless of whether 'income' is directly received.

(c) Welfare interface:

There has been no change[3] to the way in which income is calculated or attributed to individuals when the government calculates entitlements to:

- Working for Families;
- Student loans;'
- Student allowances;
- The Independent Earner Tax Credit;
- Child support payments;
- Other welfare payments.

As the RPRC's March report noted:

> "When the state uses 'income' as a basis for calculating benefits, determining entitlements or abating them, it is almost always the income that is subject to income tax that matters[4]". (Chamberlain & Littlewood, 2010, p. 10)

The 2010 Budget has not directly affected the 'interface'. However, in a post-Budget *Fact Sheet* issued by the government[5], it seems that work is underway to look at some of the 'interface' issues:

> "The Government will urgently reform other rules relating to income for the purposes of WFF, Student Allowances and the Community Services Card. These changes include ensuring trust income is counted as part of a family's total income for the purposes of WFF. Resulting changes will apply from 1 April 2011."

The *Fact Sheet* states the government's intention to publish an "issues paper" later this year (English, 2010, p. 1).

(d) Salary sacrifice:

As the RPRC's March 2010 report points out, a further dimension is introduced by the ability of employees to sacrifice their salary in favour of an employer's contribution to a superannuation scheme.

Salary sacrifice will no longer affect the total tax immediately paid because the top personal rate will now be the same at the top Employee Superannuation Contribution Tax (ESCT) rate that employers paid as a proxy for the tax the employee would have incurred had it been paid as salary/wages. The top rate of ESCT has been left unchanged in the 2010 Budget. Previously, the employee could sacrifice pay that would have borne tax at 38% in favour of the employer's equivalent contribution at 33%. The immediate tax situation is therefore improved by removing that distinction.[6]

However, another implication of sacrificing salary is that reducing taxable pay impacts directly on 'income' counted in the state's welfare and other income-tested benefit calculations.

[3] Other than to the thresholds used to abate state benefits as proposed in the Social Assistance (Future Focus) Bill – the base threshold will increase effective 27 September 2010 from $80 a week to $100 and the secondary threshold from $180 to $200 a week.

[4] 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": paragraph f(xvi)c of the definition of "income" in section 3(1) if the Social Security Act 1964.

[5] Available here.

[6] The change will also simplify the tax landscape by removing the associated "Fund Withdrawal Tax (FWT) that was needed to limit employees' capacity to cycle pay through a superannuation scheme.

> "A decision to sacrifice salary can therefore improve a family's net disposable income, depending both on income tax and on its entitlements under these different state-administered programmes." (Chamberlain & Littlewood, 2010, p. 11)

Again, the 2010 Budget has not directly addressed this situation. It remains to be seen whether the "issues paper" promised later in 2010 will change this.

Conclusion

In summary, the 2010 Budget made only a modest move toward removing some of the complexities and inconsistencies of the current tax arrangements. The alignment in the headline rates (the top personal and trust rates) may remove some distortions but:

- The remaining gap between the new lower company tax rate and personal/trust rates remains an issue to be addressed.
- There has been no improvement in the different treatments of CIVs or in the complexities that have been created in recent years, most notably in 2007 when PIEs and the FDR were introduced.
- The interaction between 'income', income tax, and the welfare system has not, as yet, been given the attention it requires. It remains to be seen whether the promised "issues paper" takes a comprehensive look at these issues or whether, as has been the case for the last ten years or so, it provides 'sticking plaster' solutions to a situation that needs more substantial reform.

Even if the welfare-related problems could be fixed successfully through some form of imputation, there remain the other complexities and inconsistencies in the tax system that need urgent attention. Perhaps they too could be addressed by imputation, as recommended in the RPRC's March 2010 report.

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[7] Thanks to Michael Chamberlain of MCA NZ Limited, Actuaries, for his help in putting this *PensionBriefing* together.