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On the:

Taxation (Consequential Rate Alignment and Remedial Matters) Bill

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The Retirement Policy and Research Centre (RPRC) of the University of Auckland is an academically focused centre specialising in the economic issues of demographic change including public and private provision of retirement income (New Zealand Superannuation, and e.g. KiwiSaver, respectively), and both the accumulation and decumulation phases of retirement provision.

We wish to be heard by the Committee in Auckland in person or by video link.

Summary of this submission

1. The Taxation (Consequential Rate Alignment and Remedial Matters) Bill ("the Bill") aims, among other things, to align the tax rates that members of portfolio investment entities ("PIEs") will face within a PIE, given the other changes made to personal tax rates that took effect from 1 April 2009.

2. The RPRC submits that significant gaps in the tax treatment of income have been created by a 'silo approach' to recent reforms to the taxation of investment income. The changes proposed in the Bill, if enacted, will increase the current flexibility that an individual has to reduce tax by the use of collective investment vehicles ("CIVs"), including PIEs, that are 'final' taxpayers. This also affects the integrity of the relationship between 'income' and state-provided benefits of all kinds that are dependent on the amount of income an individual receives. Paragraphs 3-4 of this submission describe the difficulties of the current regime for the taxation of 'income' that have developed over the last ten years because of a 'silo approach' to reform.

In that context, the RPRC recommends that Clause 49(10) of the Bill (replacing the definition of "prescribed investor rate") be deleted and that much-needed reform should await the outcome of the work that the Tax Review Group is undertaking in this now complex area.

If the RPRC's recommendation on Clause 49(10) of the Bill is not accepted, clause 5(b) of this submission suggests a change that would limit the most obvious use of the tax planning opportunities presented by the PIE framework. This suggestion should, however, be regarded as an interim reform.

The present tax situation in brief

3. An individual faces a number of potentially different tax rates on an extra dollar of investment income. Those rates depend principally on whether the individual receives that directly or indirectly and then also depends on the vehicle through which that income has been earned. The main possibilities are:

(a) Earnings for income tax

Ordinary income tax is payable on direct cash remuneration and other directly received income. In this submission, we will refer to as the individual's "Taxable Earnings".

The tax to be paid accumulates by income band as follows:

Table 1

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%

Notes: ACC premiums for both employee and employer are based on Taxable Earnings paid directly by the employer. The permanent disability ACC pension is also based on this. Details are as at 1 April 2009.

An extra dollar of investment income received directly by the individual is therefore taxed at the appropriate marginal rate.

When considering any test of 'income' associated with the payment of any state entitlements (see sub-paragraph 3(f) below), it is usually the individual's (or the household's) Taxable Earnings that count.

(b) Fringe Benefit Tax

The 'silo approach' to the taxation of an employee's income from employment is illustrated as follows: If an employee receives non-cash benefits (like a car, a low interest loan, or subsidised or free accommodation), the annual 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.

With respect to the fringe benefit itself, the correct amount of tax may have been collected; but because Taxable Earnings are used elsewhere for the calculation of state-provided benefits (see sub-paragraph 3(f) below), where fringe benefits apply, the Taxable Earnings understate the true income the employee receives.

(c) Employer Superannuation Contribution Tax (ESCT)

Where an additional dollar of an employee's remuneration is earned by way of an employer contribution to a superannuation scheme, tax is usually payable, again by the employer as a proxy for the employee, on those contributions. The calculation of Employer Superannuation Contribution Tax (ESCT) depends on:

- the total of Taxable Earnings paid just by the employer, plus
- contributions paid by the employer to registered superannuation schemes in respect of the employee, plus
- employer contributions to KiwiSaver that exceed the tax-free limit; this limit is an amount that matches the employee's own KiwiSaver contributions but with a maximum of 2% of the Taxable Earnings paid just by the employer.

It does not include employer contributions to what the Income Tax Act calls a "Superannuation Scheme"[1]. Those are subject to FBT (as in sub-paragraph 3(b) above).

In Table 2 below, the amount that is subject to ESCT is called the "Total of Relevant Amounts".

The ESCT rate is as follows:

Table 2

Total of Relevant Amounts	ESCT rate
0 to $16,800	12.5%
$16,801 to $57,600	21%
$57,601 and over	33%

[1] 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 employer can elect to pay an alternative flat rate of ESCT rate that is 33% on all affected contributions.

In all cases, the ESCT rates are applied to the gross contribution. The net post-ESCT value is the amount actually received by the scheme.

The ESCT is not cumulative as is the case with income tax. The ESCT is *not* 12.5% on the first $16,800, 21% on the next $40,799 and 33% on the balance. So, for example, if the employer's contributions mean that the Total of Relevant Amounts is $57,601, ESCT becomes 33% of all employer contributions (including the contributions 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.

The employer is effectively paying the ESCT on the employee's behalf (as a 'proxy'). Whether or not the ESCT paid fairly reflects the income tax the employee would have paid had the contribution been part of income (it will often be less) the employee's total remuneration is not counted in the calculation of state-provided benefits (see sub-paragraph 3(f) below).

(d) For PIE income

The tax currently payable by a PIE in respect of a member depends on the total income in a financial year (ending on a 31 March) of the member's "Taxable + PIE Income". This is:

(i) the member's PAYE earnings in the year, plus

(ii) other taxable income received by the member (interest, dividends, rent etc), plus

(iii) the total before-tax PIE income (reduced by any PIE losses)[2] attributed to the member in that year by this PIE and by any other PIE the member belongs to.

The member must currently advise the PIE whether the PIE tax rate for a year (the "Prescribed Investor Rate" or PIR) should be either 19.5% or 30% as shown in Table 3 on the next page.

[2] The Income Tax Act 2007 refers to these as the "portfolio investor allocated income" and the "portfolio investor allocated loss".

Table 3

Taxable + PIE Income	PIE tax rate (PIR)
0 to $60,000	19.5%
$60,001 and over	30.0%

Notes:

1. The PIE tax rate is, like ESCT (sub-paragraph 3(c) above), an 'all or nothing' test. If either the Taxable + PIE Income 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%. Both of the tests must be satisfied for the lower 19.5% rate to apply.

2. The Taxable + PIE Income includes "portfolio investor allocated income" (less losses) from all PIEs but does not include income from collective investment vehicles that are not PIEs but that are 'final' taxpayers. Examples of these include a registered superannuation scheme or an unregistered "superannuation scheme", as defined in the Income Tax Act 2007.

The 'year' to which these tests apply is not straightforward – it applies only to complete financial years ending 31 March and if the test is satisfied in either of the last two financial years, the present lower PIE tax rate of 19.5% 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 but the Inland Revenue has the power to change the effect of that election if the member was wrong.

The PIE is again effectively paying the tax on the member's behalf (as a 'proxy'). Whether or not the PIE tax rate fairly reflects the income tax the member would have paid had the PIE income been part of income (it will usually be less) the member's total taxable income is not counted in the calculation of state-provided benefits (see sub-paragraph 3(f) below).

(e) For calculating Fund Withdrawal Tax (FWT)

FWT of 5% is due on the payment of a benefit by an employer-sponsored, registered superannuation scheme. The rules for this are complex and there are exemptions but the 'income' that triggers the potential FWT liability is as follows:

Taxable Earnings, as in sub-paragraph 3(a) above and including other taxable income **plus** all the employer's contributions paid to any registered superannuation scheme by any of the member's current employers (including previous employers) in the current year and during the four preceding financial years.

We will 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[3]. That also applies to an employer's contributions to an unregistered "superannuation scheme" as they have been subject to the FBT regime for contributions (sub-paragraph 3(b) above).

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 that the FWT Total is less than $70,000.

(f) Interaction with state benefits

The net value to a saver of an extra dollar of investment income is affected by the way in which it has been earned, and by the interaction between that 'income' and benefits delivered by the state.

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.

In each case, it is the earner's Taxable Earnings (defined above) that count (in some cases, the household's Taxable Earnings). To the extent that 'income' is either sheltered in vehicles that are 'final' taxpayers, or that does not count as Taxable Earnings (such as the fringe benefits described in sub-aragraph (b) above), the individual may both reduce tax and increase state entitlements.

The Bill's proposal in summary

4. With respect to PIEs (see sub-paragraph 3(d) above), the Bill proposes replacing, from 1 April 2010, the two step PIR with a two-layered, three step version that echoes the first three of the four step treatment of directly earned income (sub-paragraph 3(a) above). As Table 4 on the next page shows, there are five possible combinations that matter.

[3] Section CS 10B of the Income Tax Act 2007.

Table 4

Taxable Earnings	Taxable + PIE income	PIE tax rate
$0 – $14,000	$0 – $48,000	12.5%
$0 – $14,000	$48,001 – $70,000	21%
$14,001 – $48,000	$0 – $70,000	21%
$48,001 and over	n.a.	30% (on PIE income)
n.a.	$70,001 and over	30%

Adapted from (Inland Revenue Department, 2009, p. 6)

What was effectively a double test (taxable earnings of $38,000 and Taxable + PIE Income of $60,000) has been replaced by a two-layered test so that an investor in a PIE must establish:

- First, whether Taxable Earnings are either less than $14,000 or between $14,001 and $48,000, and, for the same year,
- Secondly, whether the Taxable + PIE Income is either less than $48,000, between $48,001 and $70,000 or more than $70,000.

The RPRC's comments

5. The rationale for the introduction of PIEs was to allow the income attributable to members of PIEs to be taxed at something akin to the individual's marginal tax rate.

The commentary that accompanied the current Bill implies that the changes are essentially of a mechanical nature:

> "These [PIE] rates should be aligned with the new personal tax rates ... This is to ensure that investors are not disadvantaged if they invest in a PIE rather than investing directly. This is particularly important as the tax on PIEs is a final tax.
>
> "The PIE rates are capped at 30% so they align with the company tax rate of 30%. This alignment was necessary so that an investment in a PIE was not disadvantaged compared with an investment in, for example, a company that was not a PIE." (Inland Revenue Department, 2009, p. 6)

Perhaps the added complexity of the new two-layered test could be justified if PIE investors were indeed paying the 'correct' amount of tax. Unfortunately, the added complexity makes an already complicated arrangement even more difficult to understand and administer. It also has potential significance for the integrity of the welfare system as investors recognise the planning opportunities that combinations of 'final' tax payer investment entities present.

Specifically:

(a) **Removing the 19.5% rate:** The RPRC supports the removal of 19.5% as a possible PIR. It was difficult to understand why that rate was ever chosen as it can apply only to an investor with no taxable income from earnings and who had investment income of less than, previously, $38,000 a year. If there are to be different PIRs, they need to be aligned with the tax rates that investors pay on their other income.

(b) **Removing the tax advantage for wealthier taxpayers:** If PIRs are to reflect the personal tax rates then the RPRC does not understand why they are capped at 30%. The rationale in the commentary that accompanied the Bill was that it was necessary to align the top PIE rate with company tax rate so that an investment through a company was not preferred. That logic is flawed. The correct comparison should be between personal tax rates and PIRs; that was the reason for introducing the PIE concept in the first place. The disconnect is actually between the company tax rate and personal tax rates. If there is reform needed, it is in the alignment of those rates.

There therefore seems no justification for conferring a tax advantage on wealthier members of PIEs: all those whose Taxable Earnings are more than $48,000 a year.

The RPRC recommends that the distinction in Table 4 between "Taxable Earnings" and "Taxable + PIE income" be abolished and replaced by a single test of "Taxable + PIE income".

As well, the PIRs should be the same as the personal rates set out in Table 1. To promote compliance with the tax regime rather than avoidance, whether a PIE member receives income directly or through a PIE should be immaterial for tax purposes. Both are in fact 'income' and both should be treated alike.

(c) **What counts as 'income' for state benefits:** We have already noted that what counts as 'income' matters not just for the calculation of income tax but also for the entitlements an individual has to a number of state-provided benefits – see sub-paragraph 3(f) above. Given the amounts that individuals can save in tax or by receiving additional entitlements through re-arranging their investment vehicles, this income anomaly also needs to be addressed.

As it is not really a matter of tax policy, this matter could be addressed independently of the work being done by the Tax Review Group.

As an example of a current inconsistency, in calculating a PIE investor's PIR, the before-tax income attributable in other PIEs must be used to calculate Taxable + PIE Income. The RPRC suggests it is illogical to exclude the before-tax income attributed to a member of a superannuation scheme that is not a PIE.

Limiting the ability to shift income

6. Attached to this submission is an RPRC *PensionBriefing* that illustrates how the current regime and tax treatment of 'income', PIE income and income derived from a registered superannuation scheme can be manipulated to the advantage of a wealthy investor.

As shown in the *PensionBriefing*, a wealthy couple can presently reduce total tax payable, in the example of investing $5 million, from $84,550 a year to $60,440. At the same time, the couple can qualify for a number of income-tested benefits.

The changes proposed in the Bill would enable that example couple to further reduce their tax payable from $60,440 to $58,200. The RPRC suggests that allowing investors this level of flexibility to manipulate their taxable income, a direct consequence of the 'silo approach' to the taxation of CIVs, is not good policy.

Conclusion

7. In summary, the RPRC suggests that New Zealand needs to adopt a more comprehensive definition of 'income' that would simplify the environment and make it less prone to re-arrangement for tax and welfare gains.

Reference:

Inland Revenue Department. (2009). *Taxation (Consequential Rate Alignment and Remedial Matters) Bill - Commentary on the Bill*.

If I won $5 million: structuring investments to maximise after-tax income

RPRC *PensionBriefing* 2009-4

To illustrate the growth of complexity and resulting inequities in the current tax environment, this *PensionBriefing* outlines the way in which investments may be structured to maximise their after-tax returns. In order to describe the issues involved, the *PensionBriefing* takes a hypothetical case of winning $5 million.

Not many people win a large amount of money on Lotto – that's why the top prize can be so large. However, selling a business or receiving an inheritance could see a relatively large amount of capital available for retirement income. We examine the use of 'portfolio investment entities' and registered superannuation schemes, including the case where New Zealand Superannuation is payable.

This *PensionBriefing* is a companion piece to *PensionBriefing 2009-3* - *Structuring remuneration to maximise value through salary sacrifice*. That showed how a hypothetical employee on a pre-tax remuneration of $150,000 a year could, with a cooperative employer, use current rules to increase after-tax remuneration by $6,125 a year.

Here we look at using current rules to increase the after-tax value of investment income using different vehicles. The main point of these two *PensionBriefings* is not to offer tax, investment or remuneration advice but to point out:

- the complexities of New Zealand's current income tax environment;
- how far New Zealand has moved from a comprehensive definition of 'income'.

Assumptions

This *PensionBriefing* assumes that an individual invests $5 million at a pre-tax interest rate of 5% per annum, the equivalent of a conservative estimate of a return from a cash-based investment. The gross annual income is therefore $250,000. It also assumes the individual (and, where relevant, the individual's partner) has no other taxable income.

Investing directly

If the individual had no other taxable income, the after-tax income from the $5 million is shown in Table 1:

Table 1

Individual investing directly	
Before-tax	$250,000
Tax	$84,550
Net after-tax	$165,450
Net as % of gross	66.2%

Note: the income tax bands and rates current at the date of this *PensionBriefing* are at 1 April 2009.

If the individual were one of a couple, a relatively simple step (**Step 1**) would be to split the money evenly to maximise the advantage of the lower income tax bands. That can be done through an agreement under the Property Relationships Act with no gift duty implications and with immediate effect (no gifting programme needed). After the split, Table 2 shows the combined position:

Table 2

Couple investing directly			
	Partner 1	**Partner 2**	**Total**
Before-tax	$125,000	$125,000	$250,000
Tax	$37,050	$37,050	$74,100
Net after-tax	$87,950	$87,950	$175,900
Net as % of gross	70.4%	70.4%	70.4%

This Step 1 would save the couple $10,450 a year in tax.

For the rest of this *PensionBriefing*, the calculations will stay with the couple as that best illustrates the advantages of restructuring ownership of the investment asset.

Step 2 - Using a PIE and a 'registered superannuation scheme'

A 'portfolio investment entity' (PIE) is a tax-efficient investment vehicle. That means the investors will pay less tax investing in exactly the same asset ('cash' in this example), as the couple would have done owning the investment directly. The rules that apply to PIEs are complex.

The lower tax rate that applies to PIE income is presently 19.5%. As this is more than the lowest personal rate (12.5% on income to $14,000 a year), it makes tax sense for each of the couple to earn at least $14,000 a year directly. On the assumptions, each of the couple should keep $280,000 in their own names: 5% on $280,000 is $14,000.

Then, in the present case, after the spilt (Step 1), each of the couple should contribute sufficient to a PIE so that the pre-tax PIE income is no more than $46,000 a year. That means the total of the direct investment income and the PIE income is no more than $60,000 a year. Using an investment return of 5% a year, each Partner will contribute $920,000 to the PIE and, on the assumptions, the tax rate that applies to the PIE-derived income will be 19.5%.

Had all the money been contributed to the PIE, tax of 30% would have been payable on all the income generated by the PIE.

Instead, the rest of the money ($1.3 million) should be contributed to a registered superannuation scheme that is not a PIE. The tax payable on this income will also be at 30%. The income earned in that scheme is not included in the Partners' own tax returns; nor does it count in the calculation of the PIE tax return[4]. The superannuation scheme is a 'final' taxpayer.

Table 3 shows the new position for the couple.

[4] It also does not count when entitlements are assessed for Working for Families' payments; the new Independent Earner Tax Credit; nor for student allowances, child support and maintenance payments to a former partner.

Table 3

Couple investing directly and using a PIE and superannuation scheme			
	Partner 1	**Partner 2**	**Total**
(a) Directly			
Before-tax	$14,000	$14,000	$28,000
Tax	$1,750	$1,750	$3,500
Net after-tax	$12,250	$12,250	$24,500
(b) PIE			
Before tax	$46,000	$46,000	$92,000
Tax	$8,970	$8,970	$17,940
Net after tax	$37,030	$37,030	$74,060
(c) Super scheme			
Before tax	$65,000	$65,000	$130,000
Tax	$19,500	$19,500	$39,000
Net after tax	$45,500	$45,500	$90,000
Totals			
Tax	$30,220	$30,220	$60,440
Net income	$94,780	$94,780	$189,560
Net as % of gross	75.8%	75.8%	75.8%

This Step 2 would save the couple income tax of:

- $24,110 a year over the amount that the 'single' investor would pay if all the investment income were earned directly;
- $13,660 a year over the amount the couple would pay after splitting the investments (Step 1).

When the older partner reaches age 65

This *PensionBriefing* has assumed so far that the individuals have no other taxable income. That changes when the older partner reaches age 65 and starts receiving New Zealand Superannuation (NZS). NZS is taxable income received by each in their own right and cannot be assigned.

(a) Partner 1: The arrangement in Table 3 will now need to change because Partner 1 will receive NZS of, currently, $14,229 a year before tax. This is almost the same as the first tax band at 12.5% covers (up to $14,000 of taxable income) so Partner 1 should now make a further contribution of the $280,000 investment directly held to the registered superannuation scheme (not the PIE).

A small amount ($4,580) should also be shifted from the PIE to the superannuation scheme to ensure that the total of NZS and the PIE income does not exceed $60,000 a year. This will leave $915,420 in the PIE ($920,000 - $4,580) providing, on the assumptions, income of $45,771 a year before tax.

There will now be a total of $1,584,580 in the registered superannuation scheme for Partner 1 providing before tax income of $79,229 ($55,460 after tax at 30%).

(b) Partner 2: There is another consideration that may now apply with respect to Partner 2. NZS can be payable to a person before reaching age 65 but that is subject to an income test. Under the current rules, income earned through a PIE or a registered superannuation scheme is not 'income' for this purpose. As long as the couple's before-tax income is less than $4,160 a year ($80 a week), the younger partner in the example can also receive NZS. On that basis, Partner 2 should also re-arrange the investments in the same way as Partner 1 so leaving the couple with no directly taxed investment income. There would not be any point in having the $4,160 concession available before the income test bites. That's because the $4,160 would be taxable at 21% which is more than the PIE's 19.5%. However, depending on the couple's spending needs and other realisable assets, draw-downs by either Partner from the arrangements described above may be deemed to be 'income' for this purpose – see paragraph (e) on page 13 for more on this.

Partner 2 should maintain those arrangements after reaching age 65 and becoming directly entitled to NZS.

Investment return

This *PensionBriefing* has used a 5% p.a. return as an example. In practice, the returns in each of the investments will be driven by the Partners' chosen investment strategy (and the markets). Given the tax significance of keeping the combined total of direct investment income and PIE income below $60,000 each in at least one of the last two financial years, the total will need to be monitored. The test is an 'all or nothing' one: if the total exceeds $60,000 in both of the preceding tax years by only one dollar, then all the PIE income will be taxed at 30% (the same rate as in the registered superannuation scheme). Money might need to be shifted from the PIE to the registered superannuation scheme to avoid that.

On the other hand, because the test is based over two years, if the Partners each qualify this year, it doesn't matter what they earn next year (and its mix between direct and PIE income) as long as they each re-qualify in the following year.

In the example used in Table 3, the penalty for breaching the $60,000 total would be extra tax of $4,830 for each Partner ($13,800-$8,970).

Superannuation as a planning tool

This *PensionBriefing* illustrates how the new tax rules may be used for planning purposes. Using a PIE and a registered superannuation scheme may offer individuals advantages over more traditional financial planning tools such as family trusts for the following reasons:

(a) Low cost: The above arrangements do not require the Partners to establish complex family trusts or corporate entities[5]. The couple can use publicly subscribed vehicles offered by most financial service providers. There will be investment management fees and perhaps also some relatively small membership fees but most of those would also be payable if individuals established their own arrangements and used professional investment managers.

If the couple had particular investment requirements, the registered superannuation scheme could be a vehicle established specifically for the couple. However, that would involve regulatory compliance (investment statement, annual audited accounts, annual return to the Government Actuary etc).

It would not be possible for the couple to have their own PIE because the ownership concentration rule for a PIE requires at least 20 'unassociated' members and each holding comprising no more than 20% of the voting rights in the underlying investment.

[5] There may be other reasons for establishing those vehicles such as the protection of infant beneficiaries, creditor protection or protection against potential property relationship claims.

(b) **Immediate effect:** Because each of the suggested transactions involves a contribution to a scheme in the member's name, there would be no question of gift duty and so no gifting programme as is usually needed in the case of a family trust.

(c) **Ownership:** The money in each case belongs indirectly to the two individuals. That means there is no loss of control; nor is there any need for consideration of the needs of other potential beneficiaries as can happen with a family trust. It also means that, on death, the money can form part of the member's estate or, depending on the scheme's rules, could be passed directly to nominated beneficiaries.

(d) **Flexible:** Each of the steps suggested can be unwound if tax or other rules change (as they may). The Partners should be careful to ensure the PIE and registered superannuation scheme allow them immediate access to withdrawals to that end. There are schemes that allow that.

(e) **Living expenses:** Part of the point of the suggested structure is to provide the couple with retirement income. They should use the money in the registered superannuation scheme for this purpose, not the PIE. The couple can establish a regular monthly drawdown with some superannuation providers and would need to ensure that was possible before making contributions. Being also able to withdraw *irregular* amounts would be an advantage. Amounts received in this way are not taxable but will be received as capital. They will therefore not affect the tax status of the arrangements described.

If Partner 2 is to receive NZS before age 65, the regular drawdown by either Partner to meet living expenses may be deemed to be 'income' for the income test, even though, for tax purposes, it is actually after-tax capital. Work and Income NZ has considerable discretion as to what counts as 'income' for this purpose. If the arrangement were intended to apply for a relatively short period, it might be possible for the couple to use some form of non income-earning but accessible asset to help meet living expenses until Partner 2 reached age 65.

(f) **Salary payments:** If either Partner has an income earned from employment, that can be 'salary sacrificed' in full to the registered superannuation scheme (not the PIE) without affecting the tax arrangements described above. If the employer is using the variable 'employer superannuation contribution tax' (ESCT) rates, the tax deducted from the sacrificed amounts would be 12.5%, 21% and 33% depending on the amounts involved[6]. This will effectively allow the Partner concerned to have a double tranche of income taxed at only 12.5%. This is because the variable ESCT rate is based on the income (before salary sacrifice) derived just from that employer and not on the employee's total taxable income from all sources.

Comment

This *PensionBriefing* illustrates the now complex interaction between the 'income' earned directly and through vehicles that are taxed as a proxy for the members involved. It also illustrates the impact of definitions of 'income' on potential entitlements to income-tested welfare payments.

The point of analysis is not to recommend that any individual investor re-structures their investment in this way; rather, it is to highlight the need for an urgent review of policy in this area before such techniques are widely adopted. In principle, it is difficult to support an environment where the total tax payable by the couple depends not on the returns earned by the underlying investments (in the example,

[6] See *PensionBriefing 02/2009* here for more on the 'salary sacrifice' rules.

cash) but rather on the way they structure their holdings. It may be even less supportable for welfare payments by the state to be also directly affected by that structure.

A return to a more comprehensive definition of 'income' would make the environment simpler and less prone to re-arrangement simply for tax and welfare gains.

For comments on this briefing and further information please contact:

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