

Submission

By

Business|NZ

To

Inland Revenue Department

On

Countering Extreme Salary Sacrifice

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**COUNTERING EXTREME SALARY SACRIFICE
SUBMISSION BY BUSINESS NEW ZEALAND¹
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1. INTRODUCTION

- 1.1 The taxation system has a critical role to play in attracting investment and fostering a dynamic, productive and innovative economy. High tax rates and complex compliance requirements impose significant costs on the economy, including lower investment, output, incomes, and employment as well as distortions in behaviour. In addition, the ability for New Zealanders to save (either as part of general or retirement savings) provides various benefits, ranging from feelings of security for the individual, through to lifting the burden of government to provide for its citizens now and in the future.
- 1.2 Business New Zealand welcomes the opportunity to comment on the Countering Extreme Salary Sacrifice Discussion Document (referred to as 'the document') that the Inland Revenue Department (IRD) has released.

2. SUMMARY OF RECOMMENDATIONS

- 2.1 Overall, Business New Zealand makes the following recommendations:
- (a) **The recommended changes regarding salary sacrifice and SSCWT outlined in the document do not proceed;**
 - (b) **The Government introduces a lower flat tax structure as the primary way to resolve perceived anomalies in New Zealand's tax system.**

Without prejudice to the above recommendations, if changes were to proceed, Business New Zealand recommends that:

- (c) **The IRD do not take any retrospective action on those who have entered into SSCWT arrangements that would be considered 'extreme' by IRD.**
- (d) **Providing there is overwhelming support from other submitters, Business New Zealand would support the proposed removal of the 39% and PAYE methods for calculating SSCWT.**

3. BACKGROUND

- 3.1 The document represents the culmination of a period of background consultation with various groups regarding New Zealand's employer superannuation schemes and Specified Superannuation Contributions Withholding Tax (SSCWT). Business New Zealand is grateful to be included as part of that background consultation process, as the issue is an important one for many employers and their employees amongst our membership.

¹ Background information on Business New Zealand is attached as Appendix 1.

3.2 While the document is relatively straightforward in terms of outlining the changes recommended, Business New Zealand would like to take the opportunity to challenge the views of the IRD regarding the prevalence of 'extreme salary sacrifice'.

4. PREVALENCE OF EXTREME SALARY SACRIFICE

4.1 The document focuses on the issue of 'extreme' salary sacrifice, i.e. those who are allocating a large proportion of their salary or wages to minimise the amount of tax that they pay. The IRD have stated that such behaviour undermines the fairness of the tax system, and brings about costs to the economy when tax rules encourage people to rearrange their affairs to reduce their tax burden.

4.2 To rectify this behaviour, the two key changes outlined in the discussion document are:

- Changing the SSCWT rate based only on salary and wages to that of salary and wages + contributions to the superannuation fund, and
- An increase in the bands for progressive rates by 15% to minimise the possibility of over-taxation by other contributors.

4.3 When IRD consulted with Business New Zealand during the initial stages of investigating this issue, we were asked whether we knew or had any indication of the prevalence of 'extreme' salary sacrifice solely for minimisation of tax within our membership. Any notion of the level of 'extreme' salary sacrifice amongst our membership of around 76,000 employers is almost impossible to ascertain. During IRD's consultation with Business New Zealand, IRD did concede that finding 'hard' evidence was indeed difficult, which in turn has meant the document also lacks any indication of the scale of the perceived problems, apart from broad references to *"a number of tax schemes that use extreme salary sacrifice to minimise the amount of tax that participants pay"*. Therefore, from our view recommendations that are based on a lack of hard evidence and a lack of a definition of what is considered 'extreme' makes support for the changes proposed difficult.

4.4 As well as the unavailability of conclusive evidence that this is a widespread problem, Business New Zealand has maintained that the proportion of people who would be in a position to contemplate, let alone actually take up extreme salary sacrifice would be very small. It only applies in circumstances that most employees do not find themselves in. Even the document points out that *"reducing tax through salary sacrifice is likely to be available only to employees who have large assets or income from other sources or who are supported by someone else"*. We would assume that the Government already knew that these would be the few cases where 'extreme' salary sacrifice could occur when various changes were made to the scheme over the past five years. In addition, it would also be fair to assume that the vast majority of people who are using salary sacrifice are doing so for legitimate purposes.

- 4.5 Indeed, salary sacrifice and SSCWT has already experienced considerable change over recent periods. From Business New Zealand's point of view, these changes play an integral role in examining the current recommendations in their entirety.
- 4.6 The first broad round of changes that have led us down the path of the current recommendations began in April 2000 when the top personal tax rate was changed from 33% to 39%, thereby creating a gap of 6% between the SSCWT rate and the top personal tax rate. The fact that the SSCWT stayed at 33% was a way in which those on a 39% marginal tax rate were in effect rewarded for sacrificing part of their salary/wages towards their superannuation savings (i.e. a tradeoff of postponing consumption now for later). It is interesting to note that at that time, the Government was not averse to some loss in tax revenue:

"The aim is that genuine superannuation savers, even if they are high income earners, will be taxed at 33 cents. This incentive may persuade people to increase their superannuation savings, with some loss of potential tax revenue to the Government, but we are not averse to this"

Dr Michael Cullen – Government Press release (18 February 2000)

- 4.7 Realising that the current set up meant those who were on a top personal tax rate of less than 33% were paying SSCWT at 33%, the Government sought to introduce further changes by way of a progressive regime for SSCWT in April 2004 to closely align SSCWT and personal tax rates for middle and low income employees. Since the SSCWT rate was based on wages and salaries, those on a high income could access lower personal tax rates through sacrificing a large proportion of their income for retirement.
- 4.8 Currently, those who sacrifice income in this way can withdraw the money before retirement, but have to pay a fund withdrawal tax of 5%, which removes some of the incentive for salary sacrifice, but not all. One could argue that those who sacrifice 'extreme' amounts and then withdraw the funds after a short period of time are exploiting the current system by way of spending the tax savings in the current period and not for retirement purposes. However, those who choose to leave the funds untouched until retirement age are indeed saving for retirement as the scheme is designed to do. In effect, the proposed changes tar everyone with the same brush, with the possibility of those devoting large sums for legitimate retirement purposes.
- 4.9 Furthermore, Business New Zealand is concerned that IRD's lack of defining what 'extreme' salary sacrifice is does not preclude further tinkering in the future for the regime. For instance, let's take two examples outlined in table 1. Both John and Kylie are well above average income earners (\$750,000 and \$200,000 respectively), and both devote the maximum amount of income towards employers' superannuation schemes. By doing this, after year one John annually saves \$171,270 on tax payments, while Kylie saves \$39,270 on tax payments. From IRD's point of view, both may (or may not) be deemed to be cases of extreme salary sacrifice.

Table 1: Before Proposed Changes to SSCWT

John		Kylie	
Wage/Salary	\$750,000	Wage/Salary	\$200,000
Annual income tax paid	\$283,770	Annual income tax paid	\$69,270
2 nd Year		2 nd Year	
Revised Wage/Salary	\$9,500	Revised Wage/Salary	\$9,500
Tax on wage/salary (15%)	\$1,425	Tax on wage/salary (15%)	\$1,425
Tax on employer superannuation contributions (15%)	\$111,075	Tax on employer superannuation contributions (15%)	\$28,575
Total tax paid	\$112,500	Total tax paid	\$30,000
<i>Total tax savings</i>	<i>\$171,270</i>	<i>Total tax savings</i>	<i>\$39,270</i>

4.10 Table 2 illustrates the outcome of the recommended changes to SSCWT. Here, both John and Kylie do not attempt to access the lower SSCWT rates of 15% and 21%, but still devote the largest proportion of their income into their employer superannuation scheme. While it is clear that both now have a reduced tax savings from the changes made, both still save a considerable amount on tax savings. Because of a lack of guidelines to what is viewed as extreme, one could argue that at \$41,400 and \$8,400, there is still a level of extreme salary sacrifice taking place for both individuals, which may lead the Government to instigate further change, especially if the overall tax revenue base becomes a concern in years to come.

Table 2: After Proposed Changes to SSCWT

John		Kylie	
Wage/Salary	\$750,000	Wage/Salary	\$200,000
Annual income tax paid	\$283,770	Annual income tax paid	\$69,270
2 nd Year		2 nd Year	
Revised Wage/Salary	\$60,000	Revised Wage/Salary	\$60,000
Tax on wage/salary (15%-39%)	\$14,670	Tax on wage/salary (15%-39%)	\$14,670
Tax on employer superannuation contributions (33%)	\$227,700	Tax on employer superannuation contributions (33%)	\$46,200
Total tax paid	\$242,370	Total tax paid	\$60,870
<i>Total tax savings</i>	<i>\$41,400</i>	<i>Total tax savings</i>	<i>\$8,400</i>

4.11 The changing nature of work also means one cannot consider the standard 9am-5pm position with an employer throughout the length of their working lives as standard practice anymore. People now move more frequently from job to job, with many in contract positions, and often take time out of the workforce for various reasons. Salary sacrifice provides an opportunity for the provision of retirement savings at the current period in time, because future savings for retirement is uncertain. Many women find themselves in this position, which often drop out of the workforce once they have children, or substantially scale down their type of job or number of work hours. Therefore, they take the opportunity to save substantial amounts as that level of income may not be an option for the future.

- 4.12 Also, Business New Zealand would question the view of a large uptake in extreme salary sacrifice when overall tax take figures are examined. The Minister of Revenue has recently stated that the total tax collected from employer superannuation contributions for the year to June 2003 was \$448 million. For the year ended 30 June 2004, this had risen to \$563 million. However, it is important to note that the change to marginal tax rates for SSCWT took place on April 1 2004; meaning only 3 of the 12 months could be used for what the IRD deemed to be extreme salary sacrifice. Furthermore, tax take from SSCWT fell 3.7% to \$542 million for the June 2005 year. These figures certainly do not give the impression that extreme cases of salary sacrifice are becoming increasingly widespread.
- 4.13 Lastly, Business New Zealand believes that the changes represent yet another series of never-ending changes to a scheme that will create further confusion and compliance for both employers and employees. These changes instill little confidence that there is any possibility that the scheme will be left for a reasonable period of no change as far as employers are concerned. Compliance costs associated with tax tend to make up the largest proportion of total compliance costs, at around 40% as of 2005². While we would assume that the IRD provide clear and concise details of the changes to employers and employees, another round of changes provides little assurance for the long-term future of the scheme.
- 4.14 Therefore, given the a lack of hard evidence, further confusion and compliance placed upon employers, and the possibility of further changes given previous actions, Business New Zealand does not recommend that the changes to SSCWT as outlined in the document proceed.

Recommendation: That the recommended changes regarding salary sacrifice and SSCWT outlined in the document do not proceed.

- 4.15 Moreover, Business New Zealand would like to point out that as the recent chain of events leading to this began with an increase in the top personal tax rate to 39% in 2000. The decision of the current Government not to introduce a flat tax structure will continue to lead to multiple 'band aid' solutions where differences between marginal tax rates are quite substantial, so as to lead to actual and perceived distortions in the tax system. The only true and equitable way of resolving this issue is through a flat tax structure, as discussed in previous tax submissions by Business New Zealand, and our recent *Tax Perspectives*³ publication.

Recommendation: That the Government introduce a lower flat tax structure as the primary way to resolve perceived anomalies in New Zealand's tax system.

² Business NZ KPMG Compliance Cost Survey 2005.

³ <http://www.businessnz.org.nz/file/934/TaxPerspectives.pdf>

5. BUSINESS NEW ZEALAND'S VIEWS ON CHANGING THE PROGRESSIVE SCALE

- 5.1 Without prejudice to the recommendation above that the preferred options regarding changes in the document do not proceed, we would like to comment on the particular recommendations in the document.
- 5.2 If the Government decides that changes are necessary, we believe the current recommendations are probably the best avenue forward. Business New Zealand agrees that the SSCWT thresholds should increase by 15% to minimise the possibility of over-taxation in comparison to salary and wages, as it would be grossly unfair on those on lower incomes devoting a proportion of their income to the scheme to be made worse off with the proposed changes.
- 5.3 Business New Zealand would be most concerned if the IRD decided to take a retrospective action on those who in their view have entered into extreme salary sacrifice arrangements by way of using existing rules to minimise tax payments. Given the lack of what is considered 'extreme', as well as the damage to the goodwill of the scheme that would arise, any moves in this area would be deeply unpopular and would lead to flow-on effects of many choosing not to salary sacrifice for retirement at any level of savings.

Recommendation: That the IRD do not take any retrospective action on those who have entered into SSCWT arrangements that would be considered 'extreme' by IRD.

6. IRD'S RECOMMENDATIONS REGARDING REMOVING COMPLEXITY

- 6.1 The document also outlines a recommendation to remove two methods that can be used for calculating tax on employer superannuation contributions. These methods involve a flat SSCWT rate of 39% and the election to include superannuation contributions as part of the PAYE system.
- 6.2 The document states that from available evidence, neither of these two methods is currently being used. Therefore, for Business New Zealand the removal of the options for simplification is somewhat of a moot point. Our view is that if the overwhelming proportion of other submitters approves this move, Business New Zealand would not oppose moves to remove the two methods discussed.

Recommendation: Providing there is overwhelming support from other submitters, Business New Zealand would support the proposed removal of the 39% and PAYE methods for calculating SSCWT.

APPENDIX 1

BACKGROUND INFORMATION ON BUSINESS NEW ZEALAND

Encompassing four regional business organisations (Employers' & Manufacturers' Association (Northern), Employers' & Manufacturers' Association (Central), Canterbury Employers' Chamber of Commerce, and the Otago-Southland Employers' Association), Business New Zealand is New Zealand's largest business advocacy body. Together with its 57 member Affiliated Industries Group (AIG), which comprises most of New Zealand's national industry associations, Business New Zealand is able to tap into the views of over 76,000 employers and businesses, ranging from the smallest to the largest and reflecting the make-up of the New Zealand economy.

In addition to advocacy on behalf of enterprise, Business New Zealand contributes to Governmental and tripartite working parties and international bodies including the ILO, the International Organisation of Employers and the Business and Industry Advisory Council to the OECD.

Business New Zealand's key goal is the implementation of policies that would see New Zealand retain a first world national income and regain a place in the top ten of the OECD (a high comparative OECD growth ranking is the most robust indicator of a country's ability to deliver quality health, education, superannuation and other social services). An increase in GDP of at least 4% per capita per year is required to achieve this goal in the medium term.

The health of the economy also determines the ability of a nation to deliver on the social and environmental outcomes desired by all. First class social services and a clean and healthy environment are possible only in prosperous, first world economies.