TAX TREATMENT OF SUPERANNUATION

REPORT OF THE CONSULTATIVE COMMITTEE

JULY 1988

26 July 1988

STATEMENT BY

Minister of Finance, Hon R O Douglas

RELEASE OF THE REPORT ON SUPERANNUATION

The Government is pleased to release this report on the taxation of superannuation prepared by the Consultative Committee on Superannuation, Life Insurance and Related Areas. The report comprehensively covers a number of complex issues relating to the taxation of retirement savings. It is a valuable contribution to taxation reform, justifying the Government's commitment to reform with consultation.

Our decisions on the Committee's detailed, technical recommendations are noted in the report. This covering statement highlights and explains our decisions on the report's key recommendations and on the other issues raised.

Response to the Report

The report endorses the thrust of the Government's taxation reform programme and the place of the superannuation taxation proposals in that programme. Most of the Committee's specific recommendations are agreed to.

As the Committee notes, the superannuation measures are part of and must be advanced consistently with the Government's wider tax reform programme. This includes the proposals contained in the final report of the Consultative Committee on Full Imputation and International Tax Reform. In particular, the full imputation and international report recommends a major reform of trust taxation. This recommendation has been agreed to.

The Superannuation Committee formed its views without the benefit of full knowledge of those other proposed tax changes. We have considered the reports of both Committees and ensured that the recommendations accepted are consistent. This has influenced our conclusions on some aspects of the Superannuation Committee's report. For example, we have as a result not advanced the Committee's suggestion that a modified taxation regime for superannuation be explored further.

Superannuation as Part of Wider Tax Reforms

On 17 December 1987, the Government announced proposed changes to the way in which superannuation scheme savings are to be taxed. Essentially this involved removing the tax privileges which superannuation enjoyed relative to other forms of saving and investment. This was advanced as part of the Government's general tax reform programme of lowering tax rates and removing the artificial distinctions, penalties and privileges which had undermined the New Zealand tax system and the performance of the economy generally. As this programme continues, we are moving from a system with high taxes which the rich avoid, to a system with lower tax rates which everyone pays. The need to include superannuation in this overall review of the tax system was signalled in the 1984 Budget.

More particularly, the superannuation proposals were part of, and indeed made possible, other taxation reforms such as the restructuring of the personal tax scale with, in general, lower and less variable tax rates. In conjunction with the dividend imputation system, details of which were also announced in December, the proposed superannuation measures will move us towards a more consistent tax treatment of different forms of investment and saving.

Value of the Consultative Process

To the extent to which it is possible and practical, the Government has sought public input into the tax reform process by way of the consultation process. In accordance with this policy, a Consultative Document on Superannuation was released in March and a committee of private sector experts appointed to consider the proposals and public submissions on them. The potential for abuse of the tax concessions once reform had been signalled made it necessary to enact some of the new measures at an early stage. These measures were kept to a minimum.

It was always recognised that the timetable for consultations was tight. However, extending that timetable would also extend a period of uncertainty for the superannuation industry. A lengthy consultative period would therefore have been counter-productive.

Committee's Terms of Reference

At an early stage in its deliberations, the Committee sought clarification that its terms of reference enabled it to consider and comment on policy aspects underlying the proposals. This was readily agreed to.

As a result, the Committee's report is a comprehensive review of the taxation of retirement savings. This is a valuable and considered analysis of complex issues. Committee members are to be congratulated on their efforts and the quality of the report, especially given the time constraints which, of necessity, they had to work under.

Committee Supports a Non-Concessionay Tax Regime for Superannuation

The Committee, in its report, agrees that "there is no good basis for providing tax concessions to particular types of institutions" and goes on to endorse "the desirability of neutrality in tax matters" (page 10).

The reasons for removing superannuation tax privileges were set out in the Consultative Document. Briefly, these were that such privileges:

a are expensive in terms of tax revenue forgone and thus require everyone else to pay higher tax rates;

b are unfair in that they benefit the rich rather than those who may need Government assistance;

c are frequently abused so as to benefit the rich even further; and

d incur high economic costs by distorting investment behaviour and remuneration structures, and by requiring savings to be heavily regulated so as to reduce tax abuse.

The Committee was presented with the argument which has frequently been advanced in the media that superannuation tax privileges are in fact enjoyed on an equal basis by all income groups. The Committee considered this argument, but found it lacking. As stated in page four of the report:

> "High income earners typically save more in tax (because of their higher marginal tax rates) for any given level of superannuation exemption than do low income earners; high income earners are able to save a higher proportion of their income, and shelter the income on that savings through superannuation schemes, than can low income earners; and . . . it is the high income earners who receive overwhelmingly the largest part of the employer subsidies."

The Committee has expressed concern that the removal of superannuation tax concessions would, taken in isolation, "probably result in some reduction in aggregate savings" (page 17) although it considered claims of a large fall-off in savings to be "unduly alarmist". Furthermore, the Committee "acknowledges that there is much in the overall tax reform programme - dividend imputation, GST, and lower [personal] and company tax rate[s] to mention the major items - which does reduce the rate of tax on savings." (page 10).

The tax reform programme, of which superannuation is a part, provides significantly increased incentives for effort and saving. This can only be good for the economy. Moreover, the Government's responsible approach to its own spending and budgetary position is ensuring that New Zealand is reversing the past tendency to spend, borrow and hope.

With respect to superannuation tax privileges in particular, the existence of those concessions has meant that in the past the industry has tended to sell superannuation as a tax break. There has been no need to sell superannuation and other forms of retirement savings on its intrinsic merits which are considerable. If the vast resources of this industry are redirected from selling tax concessions to educating the public about the need to save for retirement, a more secure pool of savings for investment and growth will result. This is already beginning to happen.

In addition, a more flexible and competitive superannuation industry should result from the reforms being put into place. This should lead to a better service being provided to savers who will have a greater ability to move their funds to the institutions best meeting their requirements. This will also improve the incentives to set aside savings for retirement or for other purposes.

The Government Superannuation Fund (GSF)

The Committee recommends that the GSF be reviewed to ensure that GSF members are not advantaged relative to their private sector counterparts. In discussing the changes that would need to be made to private sector schemes following the tax reform, the Committee suggests that:

> "it would be quite intolerable if the members of the GSF were insulated from changes of that kind simply by virtue of the Government's ability to 'write a cheque on the taxpayer'."

The Committee also expresses serious reservations about the desirability of continuing with the provision of fully inflation-adjusted pensions for members of the GSF. In particular, the Committee notes that "no private scheme can hope to offer benefits of comparable value", and recommends that this preferential treatment be withdrawn in the context of the renegotiation.

The Government agrees that the benefits available under the GSF scheme should be renegotiated on the same basis as the benefits of private sector schemes. The issue of inflation adjustment is one of a number of issues that could be considered in the course of renegotiating GSF benefit levels.

National Superannuation and a Modified Non-Concessionary Tax Regime for Superannuation

The Committee has recommended immediate implementation of the taxation regime for superannuation proposed in the Consultative Document with some detailed changes. It has also recommended that consideration be given to a modified non-concessionary regime in the future for pension schemes which would involve deductibility or tax-exemption of contributions to such schemes but would put an offsetting tax on pensions.

A central policy concern of the Committee's report is the desirability of a stable government policy framework in which people can plan and save for retirement. In this regard, the Committee has noted the frequent changes to the taxation regime applying to superannuation funds. It also notes similar changes to state retirement income support measures.

The Committee argues that further changes to national superannuation will be necessary because the costs of the present system are, in the Committee's view, unsustainable. The Committee expresses "serious reservations" as to whether the current costs of national superannuation are "acceptable", and states that it "has not seen any serious argument that the cost is sustainable over the next 30 to 40 years." (page 12)

The Committee thus supports a less generous form of state retirement income support with greater reliance on private provision. It identifies three obstacles to achieving a cut in the cost of national superannuation:

a the political power of those entitled to the benefits;

b the belief, erroneous in the Committee's view, that current beneficiaries are entitled to current benefit levels. It is argued that "it is simply untrue to suggest that those drawing National Superannuation have paid for it" (page 12); and

c an income-tested national superannuation scheme "produces a situation where, for many income-earners, there is little if any incentive to save for retirement."

In order to be able to reduce the costs of national superannuation, and to institute a stable policy environment for retirement, the Committee has recommended an urgent review of national superannuation on a bi-partisan basis with, in this context, consideration being given to a modified non-concessionary taxation regime for pension superannuation schemes.

The modified non-concessionary pension superannuation taxation regime suggested for consideration involves up-front deductions for superannuation contributions with an offsetting tax on 75% of superannuation benefits.

The Committee envisages that such a taxation regime would be implemented together with a revised and less generous national superannuation policy and identified the following advantages associated with it:

a a more stable income tax regime for superannuation on the basis that the Committee identified a strong public perception that the non-taxation of scheme benefits was not in accordance with normal income tax rules and that the Government would eventually tax such benefits. While the Committee sees this perception as irrational, the widely-held view that the Consultative Document's taxation regime was peculiar and unusual would discourage savings through superannuation;

b no taxation of employer contributions thus overcoming employer resistance to incurring an FBT liability;

c reduction in the disincentive to save for retirement currently imposed by the surcharge;

d removal of the tax incentive that could otherwise induce employers to internally fund employee retirement schemes to the detriment of the security of employee retirement income.

The Committee's views on national superannuation have been noted and will be borne in mind by the Government. The desirability of a bi-partisan approach is accepted and an offer to review national superannuation on a bi-partisan basis has previously been issued to the Opposition. The other issues raised by the Committee are valid and have received serious consideration.

The need for a stable taxation regime for superannuation is accepted to be imperative. For that reason also, an early decision on the Committee's recommendation to consider a modified taxation regime for pension schemes is necessary.

It is accepted that the taxation treatment of superannuation has in the past been subject to too many changes. It seems inevitable that as long as superannuation is subject to a taxation regime which is not normal, and accepted as such, that regime will frequently be changed. That is why superannuation schemes have been subject to more taxation changes than other savings entities.

There is therefore a concern if the Consultative Document's proposals are not accepted as normal and justifiable income tax treatment. As recommended by the Committee, and agreed to by the

Government, superannuation schemes will be required to be established as trusts (which means that the funds are held for the benefit of scheme members) and thus, in the absence of special provisions, they would be taxed as trusts. Therefore the most stable and justifiable taxation regime which schemes could have would be the normal tax treatment for trusts.

The Consultative Committee on Full Imputation and International Tax Reform has since made detailed recommendations proposing that the tax treatment of all trusts should be standardised and reformed. In broad terms, the recommended standard tax regime for trusts is: no deduction for settlements on, or contributions to, trusts; taxation of trust income at a single tax rate; and tax-free benefits, including benefits in income form. These recommendations have been agreed to, and this taxed/taxed/exempt regime will become the normal and standard income tax treatment of trusts.

These changes will mean that the Consultative Document's proposed taxation regime for superannuation can be implemented as consistent with, and as an extension of, normal trust income tax treatment. This should relieve the Committee's concerns that the proposed tax treatment of superannuation will be seen as abnormal and temporary.

The Committee was concerned that the Fringe Benefit Tax proposed to apply to employer contributions would discourage employer participation in superannuation schemes. To overcome this, the Committee recommends that the Fringe Benefit Tax be replaced by a final withholding tax on such contributions. The Government has accepted the Committee's recommendation.

The effect of the national superannuitant surcharge on the incentive to save for retirement is acknowledged. The Government has reserved its decision on the application of the surcharge to superannuation scheme pensions pending further consideration of the whole issue of the provision of retirement income support.

The Committee was also concerned that, if scheme earnings were taxed at a rate higher than the company rate, employers would be encouraged to run unfunded retirement income programmes for employees. The Government shares this concern. To overcome it, the 25% transitional tax rate will apply to most superannuation schemes until 1 April 1990. During that time, the question of the appropriate tax rate for fund earnings after 1 April 1990 will be reviewed. This should obviate this concern.

As the Committee's report notes, there are a number of disadvantages with their suggested modified non-concessionary taxation regime. These include the greater likelihood that current pension beneficiaries would receive a fall in after-tax income under such a regime, and greater concerns about tax avoidance opportunities. The latter would require restrictions on access to funds.

In view of the above points (especially the consistency which the original proposal would give to trust taxation in general), and the need for an early decision to enable superannuation funds to plan for the future, it has been decided not to proceed with further consideration of the modified taxation regime outlined in the Committee's report.

Summary of Detailed Recommendations on the Taxation of Superannuation

The TTE regime proposed in the Government's Consultative Document (CD), together with the Committee's recommendations for detailed changes to aspects of that regime, and the Government's decisions are as follows:

a Member Contributions: these will be made from the after-tax income of members. There will, therefore, be no personal exemption for member contributions to superannuation schemes.

b Employer Contributions: these will also be made from taxed income. The Committee recommends that the FBT on employer contributions proposed by the Government be replaced with a final witholding tax payable by employers. This recommendation is accepted.

c Scheme Earnings: under the TTE regime, scheme earnings are taxed.

d Scheme Benefits: both lump sum and pension benefits are to become tax-exempt.

e Tax Rates: the Committee proposes that a tax rate of 28% apply to both employer contributions and scheme earnings from the 1989/90 income year. The Committee accepted the logic of applying a 33% rate, but was concerned that use of a rate higher than the company tax rate would encourage employers to run unfunded schemes (ie defer paying employer contributions into the superannuation fund).

After considering the Committee's arguments, the Government proposes that, until 31 March 1990, Class A lump sum schemes and pension schemes that existed on 17 December 1987 (previously tax-exempt schemes) be subject to tax on earnings at the transitional rate of 25%. Schemes that are currently taxed at 33% and new schemes will be taxed at 33% until 31 March 1990. During the transitional period, the rate of tax to apply to scheme earnings will be reviewed in the light of the Committee's concerns.

The Committee's concerns about unfunded schemes do not apply to the tax rate on employer contributions. This is because, while the 33% rate is avoided initially in an unfunded scheme, it would still be paid later when the sum which had accumulated outside the fund was paid into the fund or paid directly to employees. Further, use of the 28% rate proposed by the Committee would create unacceptable avoidance opportunities for higher income earners. Employer contributions to superannuation schemes will therefore be taxed at 33% from 1 April 1989.

f Treatment of capital gains of superannuation funds: the Committee considers that there should be no special provisions to include realised capital gains in the tax base of schemes. The treatment of capital gains would therefore be determined by existing law. This recommendation is accepted.

g Deductibility of non-investment expenses of super schemes: it is proposed that all expenses be deductible to the fund. The Government's decision on this recommendation has been deferred pending the Committee's second report which will cover the taxation of life offices (where the same issue arises).

h Application of national superannuitant surcharge to pensions: the Committee does not support the proposal to levy the surcharge on 50% of pension benefits. It considers that the surcharge is often readily avoided and that applying it to 50% of pensions would therefore discriminate against pensions.

The Government has reserved its decision on this matter pending a review of the whole issue of the provision of retirement income support.

i Avoidance: the Committee proposes two measures to prevent superannuation schemes being used for tax avoidance. The Government accepts the need for such measures and has agreed to the recommendations subject to some minor modification.

Regulatory Regime for Superannuation

The Committee has recommended that the Government Actuary be given a new prudential supervisory role in relation to superannuation schemes. In the view of the Committee, the existing regulatory and supervisory structure within which superannuation schemes operate is insufficient to guarantee the security of members' contributions. The Committee's recommendations for reform of the regulatory structure for superannuation schemes are more complex than current law and involve important additional powers for the Government Actuary.

The Government considers that a separate regulatory regime for superannuation with an extension of the powers of the Government Actuary may not be necessary. A simpler and more flexible regulatory regime may be more appropriate for superannuation schemes.

The Committee has also proposed constraints on access to scheme benefits. While these constraints would be necessary under an ETT regime such as that considered by the Committee, or where tax concessions apply, such constraints should not be necessary under the TTE regime proposed by the Government. Decisions on the regulatory regime for superannuation funds will be released as soon as possible.

Adjustment of Scheme Benefits

The Government and the Committee agree that the date for the completion of adjustment of scheme benefits should be extended to 31 March 1990 (from 1 July 1989). It is also agreed that all existing approved schemes should be given interim registration under the new legislation governing superannuation schemes until 31 March 1989.

The Committee has suggested that it is not practical for scheme trustees to gain the agreement of scheme members where benefits need to be adjusted following the tax changes. It has therefore proposed that scheme trustees, acting in the interests of the members, should set new benefit levels under the supervision of the Government Actuary.

The Government accepts this position. However, it remains desirable for trustees to renegotiate scheme benefits with members where this is feasible. In addition, to avoid any danger that the trustees may treat the elderly unfairly, I propose that the guidelines for adjustment of scheme benefits will stipulate that the Government Actuary's approval will be dependent upon the after-tax pensions of those New Zealand resident scheme members who are in or near retirement being maintained wherever possible.

Transitional Measures

The Committee has proposed that the transitional tax rate of 25% for the earnings of Category 1 schemes existing as at 17 December 1987 apply only for 1988/89. As noted in (e) above, the Government has decided that, to ease the transition from a highly subsidised to an unsubsidised regime for superannuation savings, this rate should remain until 31 March 1990. Further, as proposed in the Economic Statement of 17 December 1987, the requirement to pay provisional tax in 1988/89 will be waived for these schemes.

Removal of the Tax on Pensions

The Committee agrees with the Government's original proposal to remove the tax on pensions from 1 April 1989, and has argued that this should not be dependent on satisfactory adjustment of benefit levels. However, to avoid unnecessary fluctuations in the net incomes of pensioners, it is desirable that the tax be removed from pensions from the same date that new pension levels are set. Accordingly, the Government has decided to remove the tax on pensions from 1 April 1990 with schemes being required to obtain Government Actuary approval before paying adjusted pensions. This will also help to reduce the windfall gains which will accrue to many existing pensioners under this reform and which were a source of concern to the Committee. It is important to note that the funds being withdrawn from pension schemes in 1989/90 will have accumulated with the benefit of exemption from taxation under an Exempt/Exempt/Taxed regime. Retaining the tax on pensions for a further year does not, therefore, raise concerns about double taxation.

The Government intends to legislate for the removal of the tax from pensions from 1 April 1990 as soon as possible.

Roger Douglas

R O Douglas
Minister of Finance

Office of the

Consultative Committee on Superannuation, Life Insurance and Related Areas

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20 June 1988

Hon R.O. Douglas MP,
Minister of Finance,
Parliament Buildings,
Wellington.

Dear Mr Douglas,

I enclose the Consultative Committee's Report on the superannuation part of Volume 1 of the Consultative Document on Superannuation and Life Insurance, which you released in March 1988. This Report deals only with superannuation.

We have also prepared draft legislation, which we enclose as an Appendix to our Report. It will be necessary to consider details and consequential changes in relation to the draft.

The Committee believes that the Government should give serious consideration to the adoption of what we call a modified exempt/taxed/taxed regime for pension schemes, in preference to the orthodox taxed/taxed/exempt approach recommended by the Consultative Document. Strictly speaking, our recommended E/T/T approach is outside the terms of reference. In these circumstances, we have prepared our Report to cover both approaches.

The Report has four main Chapters. It then contains five separate appendices, each of which deals with the details. This format will enable you to reach a decision about which regime you prefer, and provides considerable detail in relation to how that particular regime operates.

We have appreciated the assistance and advice of Allan Archer, Government Actuary, Ross Judge and Kathy Spencer of Treasury, and Greg Frontin-Rollet of the Inland Revenue Department in the preparation of the Report, and Robbie Cullen of Rudd Watts & Stone for his assistance with the draft legislation.

Yours sincerely,

Donald T. Brash

Donald T. Brash
<u>Chairman</u>

TABLE OF CONTENTS

APPENDIX 2 - TAXATION UNDER E/T/T

APPENDIX 3 - RE-NEGOTIATION OF SUPERANNUATION SCHEMES

APPENDIX 4 - THE REGULATORY REGIME FOR T/T/E AND E/T/T