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Topix
A Towers Perrin/Tillinghast Affiliate
Consulting Actuaries

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Superannuation –

Tax Proposals and an update on KiwiSaver

1. Overview

Changes to taxation of investment income

In considering the changes we comment that:

- **they provide positive value** to New Zealand superannuation schemes and to individual scheme members,
- **there are serious cost issues** for stand-alone defined contribution schemes if the changes implement the rules to advantage the 19.5% tax payers,
- **trustees will need to review** their investment benchmark asset allocations and optimise for the new regime, and
- **holders of passive overseas** share portfolios in particular will need to think whether to stay with an indexed product or change to another fund choice which may deliver better post-tax and post-fees value to members.

Update on KiwiSaver

There have been some moves on this as:

- **the submission process** has been completed, although we will not see the resulting changes until September when the revised Bill will be introduced for its second stage. By that time it will be difficult to make too many further changes to the legislation,
- **the Default Provider** Request for Proposal documents were issued in the week ending 26 May. Competition to be chosen is strong, and if Government limits the numbers there will be a number of unlucky providers,
- **employers without an existing scheme** may consider whether they wish to provide superannuation to their employees in the future, and
- **employers with existing schemes** may be tempted to convert to an exempt scheme, but this will depend on the final criteria for exempt schemes. For most schemes to convert, changes will need to be made to the proposals in the Bill.

Decisions to be made

Any employer who has a stand-alone scheme and has doubts about it continuing may consider winding up the scheme or transferring to a master trust.

Many existing schemes will probably decide to continue unchanged, with those new employees not eligible for the company scheme being enrolled into a default provider scheme.

Employers with current health insurance and/or life insurance benefits will need to consider whether they wish to integrate their response to KiwiSaver with these insurance benefits.

The final decisions on changes to existing schemes should be left until more details of the KiwiSaver rules are known.

Despite the uncertainty there is a need for trustees to stay on top of the issues and ensure that any decisions made in regard to current ongoing changes to schemes are made in the context of the new rules which will apply from April 2007.

2. Tax changes

Background to changes

The current tax regime favours the private investor over the member in a superannuation scheme, irrespective of the member's tax rate. Arguably the most favoured investor at present has assets invested in overseas shares listed in a 'grey list' country.

The current taxation regime for a superannuation scheme has:

- all investment income taxed at 33 cents in the dollar,
- all capital gains taxed at 33 cents in the dollar, except for investments in an indexed fund with an IRD ruling where capital gains are tax free, and
- no deductibility for employee contributions or employer contributions.

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The possible advantages to an employee of an investment in a superannuation scheme are limited to:

- employer contributions to the scheme where this is in addition to the employee's basic remuneration, and
- taxation of all income and capital gains at 33 cents rather than 39 cents in the dollar for the higher rate taxpayer.

In every superannuation scheme the most disadvantaged members are the 19.5% tax payers, who are heavily over-taxed by the scheme when compared to the tax rate that applies to their other income. Correcting this feature has been a driver of the tax changes and is needed, both to ensure that such members would not continue to be overtaxed and also to increase the chances of making KiwiSaver a success.

It seems that the intention to introduce KiwiSaver on 1 April 2007 has been the major driver for the introduction of the tax changes by that same date. However, we also recognise that the Government is concerned to reduce the attraction of overseas investments and build up the capital base in New Zealand.

Summary of tax changes

In summary, the changes will:

- eliminate the capital gains tax exemption for passive funds with an IRD ruling,
- eliminate capital gains tax on New Zealand (and Australian-registered company) shares,
- introduce a tax of 85% of the change in value of overseas shares, and
- introduce flow-through rules, which will tax a superannuation scheme member at their marginal tax rate, subject to a maximum rate of 33%. For a member whose previous year's taxable income was less than $48,000, the marginal tax rate will be deemed to be 19.5%.

Superannuation schemes will need to invest in a Portfolio Investment Entity (referred to as a PIE) to gain the advantages of the new tax regime. It appears that all the current collective investment vehicles will become PIEs.

The major feature of a PIE is that the tax payable on the investments of the PIE will simply depend on the marginal tax rates of the investors in the PIE. To illustrate their wide usage, charities that invest in them will pay no tax. The current rules which prevent an investor recapturing the tax imputation credits are to stay in place.

PIEs will in effect not have their own tax position, so that if a PIE has tax losses at a year end, the investors in the PIE will receive direct refunds from the IRD for their losses. The PIE will supply the IRD with the necessary details to enable the IRD to make the refund payments.

There will be transitional rules to allow the changeover from the current rules to the new ones. Gains and losses will need to be brought to account and tax paid over a 3 year period, while losses can be carried forward. A scheme will be able to reclaim expenses against the income that it generates, as applies currently.

Defined benefit schemes

There are special provisions for defined benefit schemes, which can invest in PIEs. The investment income of defined benefit schemes will be taxed at a flat 33 cents, irrespective of the tax rates that apply to their individual members. The schemes will continue to be able to receive the benefit of any tax losses.

Impact on investment returns

To assess the impact of the new tax regime, we have modelled a number of illustrative funds. For the purposes of this Topix, we have taken a balanced fund with a 60:40 growth/income asset split and with a 22.5% allocation to passive overseas share funds. More detail of the asset allocations and the investment return assumptions are given in the Appendix at the end.

The impact of the change in the tax regime on individual asset classes is illustrated in the table below, which shows the difference the new tax regime has on the 19.5% and the 33%/39% tax-paying members.

Because of the flow-through provisions, the new tax regime impacts on all the asset classes, not just shares.

The impact of the proposed tax changes is shown in the following two tables.

Table 1 - Old Tax Regime

Sector	Income %	Capital Gains %
NZ Shares		
- *Active*	33.0	33.0
- *Passive*	33.0	0.0
Overseas Shares		
- *Active*	33.0	33.0
- *Passive*	33.0	0.0
Property	33.0	33.0
NZ Fixed Interest	33.0	33.0
O'seas Fixed Int	33.0	33.0
Cash	33.0	33.0

Table 2 – New Tax Regime

	19.5% Investor		33% Investor	
Sector	Income %	Capital Gains %	Income %	Capital Gains %
NZ Shares				
- *Active*	19.5	0.0	33.0	0.0
- *Passive*	n.a.	n.a.	n.a.	n.a.
Overseas Shares				
- *Active*	19.5	16.6	33.0	28.1
- *Passive*	n.a.	n.a.	n.a.	n.a.
Property	19.5	19.5	33.0	33.0
NZ Fixed Interest	19.5	19.5	33.0	33.0
O'seas Fixed Int	19.5	19.5	33.0	33.0
Cash	19.5	19.5	33.0	33.0

In the following table is an illustration of how the tax changes impact on the net of tax returns provided to individual members.

Table 3 - Expected Net Returns

	Benchmark %	Active %	Passive %
19.5% Taxpayer			
Old	6.3	5.9	7.2
New	7.4	7.4	7.4
Variance	1.1	1.5	0.2
33% Taxpayer			
Old	6.3	5.9	7.2
New	6.4	6.4	6.4
Variance	0.1	0.5	-0.8

The returns shown the differing results that arise when the overseas shares allocation is 100% active and alternatively when the allocation is 100% passive. Of relevance, the modelling has assumed that the passive and active funds earn the same return after fees.

The specific points that we note are:

- for a 19.5% taxpayer, the return increases from 6.3% to 7.4% - a 17.5% increase in returns,
- for a 33% taxpayer, the expected return increases slightly from 6.3% to 6.4%,
- under active management the increase in the return is greater. For 19.5% taxpayer the increase is from 5.9% to 7.4%, while for the 33% taxpayer the increase is from 5.9% to 6.4%, and
- under passive management the member on a 19.5% tax rate sees an increase in the return from 7.2% to 7.4%, but a member on a 33% tax rate sees a decrease in the return from 7.2% to 6.4%.

Review of current asset allocations

The change in the tax impost will affect the risk return mix of every scheme's investments and the impact should be assessed using quantitative techniques.

While New Zealand and Australian shares become more attractive they also become more volatile, while the opposite applies to passive overseas shares. A quantitative analysis process should be undertaken to see if a higher level of return can be achieved for the current level of risk. The implementation of any asset allocation changes will also need to be made in the context of the level of the different investment markets.

Overseas passive funds

The greatest risk/return impact for a scheme will be where the scheme holds passive overseas share portfolios. There are some schemes with large holdings in passive overseas share funds which, should they decide to switch, will need to also consider how best to manage the cost and exposure issues in order to reduce costs.

Charities

Charities suffer a tax leakage by not being able to recoup the imputation credits on their income from their New Zealand shares.

There may be some chance that the Government might consider changing the rules for these entities under the new tax and PIE structure.

Comment

We note the new taxation legislation is extremely complex so that the above comments are made in the context that the current proposals in the Bill can be implemented in a practical and cost effective manner. For more information on the detail of the Bill, we suggest a reading of the newsletters put out by one of the accounting or legal firms.

3. KiwiSaver update

This Topix does not include all the details on the KiwiSaver scheme, as these can be found in our Topix of March 2006.

Key Select Committee submissions

The key areas for which we saw the need for submissions were in respect of:

- the criteria for exempt schemes, to ensure that existing schemes can continue fully into the future. Concerns were primarily in respect of the vesting and contribution rate rules and the need to allow an exemption basis for Defined Benefit schemes, and
- the application of the enrolment rules, as the present drafting means that an employee does not have any pay deductions made until more than 2 months after commencing employment.

Default providers

The selection process to determine the Default Providers will take some time, with the successful candidates not being announced until October. The outcome of the selection process will matter little to the average employer and employee.

There is perhaps an expectation that if the number of Default Providers can be kept small, the advantage of being a Default Provider will increase and the ability to deliver lower fees will be enhanced.

It is going to be hard not to argue that being a Default Provider will be an advantage to the provider's credibility. The expectation is that the Default Providers will have sufficient alternative investment options, other than the Default Option, to cover the requirements of most investors.

What should master trust providers do?

Existing master trust providers are probably going to set up both KiwiSaver schemes and exempt options schemes, either within their existing trust or alongside their existing product, using much of their existing administration systems. Existing providers such as Westpac will revamp their current offering.

We expect them to be joined by new providers who seek to enter the market place, including such mainstream providers as ANZ and ING. In addition, we will probably see some players such as Forsyth Barr, ABN Amro and Russell Investments enter the market.

An issue for the marketplace is that there will be more master trust providers and fund managers than there are experienced people to administer the schemes.

Decisions for existing schemes

Employers with existing schemes need to decide whether to do all or some of the following:

- continue with their scheme as now, make no changes and manage the KiwiSaver enrolment process to ensure the employees eligible for their scheme still join,
- convert their existing scheme to an exempt scheme to allow automatic enrolment of their employees,
- include a KiwiSaver section in their existing scheme,
- select a preferred KiwiSaver for their employees, and/or
- set up a new exempt scheme separate from their existing scheme.

Each option will have its own advantages and sometimes disadvantages.

Decisions for insurance arrangements

A large number of employers provide health insurance and other employee benefits under an insured arrangement, but have no superannuation scheme.

There is now an opportunity to review these arrangements and set up an overarching arrangement in the form of a superannuation scheme, to enable each employee to combine the management of his insurance and savings needs.

This can be achieved by setting up an exempt scheme, which will have the ability for an employee or employer to continue to pay contributions to the insurer while including some superannuation savings. The ability of an employer to do this efficiently will depend on the final exemption scheme criteria in the legislation.

Decisions if no existing scheme

For the employer who does not wish to get involved in superannuation, the employer should either:

- follow the automatic enrolment rules which will result in their employees being enrolled into one of the default schemes, or
- set up a new exempt scheme with no employer contribution, or
- select a preferred KiwiSaver scheme for employees.

In each instance, the employer retains the ability to make employer contributions to the scheme in the future.

Why offer a KiwiSaver default scheme

The particular advantages of offering a default scheme are simplicity of operation in a scheme with low fees that has a Government reviewed provider and the $1,000 initial subsidy.

Advertising campaign

Towards the end of the 2006 year and in the run up to April 2007, the Government is going to manage a major advertising campaign around KiwiSaver.

The intention of the campaign will be to raise awareness and increase the demand from existing employees to join a scheme. This will generate questions from existing scheme members, which trustees will need to manage.

UK scheme changes

At the same time as we are dealing with the KiwiSaver proposals, the UK is actively considering the future of its own pension system following the Turner review. A summary of that review is given in our December 2004 Topix.

The UK review has progressed to achieve general agreement on:

- the need to integrate properly public and private provision,
- the need for the public system to stop being means tested,
- the need to raise the retirement age above 65,
- the advantages of automatic enrolment of employees into a scheme,
- the need for both tax relief and compulsory employer contributions for schemes to be attractive to the average employee, and
- the need for low cost operation and simple scheme design, thus limiting expensive initial member advice.

4. Future scenario

Superannuation providers will always argue for compulsory superannuation. This is the business they are in, and KiwiSaver is increasingly being seen as the first step down this road. The current Government spending on its PAYE collection system for KiwiSaver can be seen as an important investment to deliver retirement savings in a cost effective manner, which has implications for the future.

The long term viability of existing stand-alone superannuation schemes must be increasingly debatable, with the expectation that in time every New Zealand employee will have their own KiwiSaver account. But despite this, it is hard to see existing schemes making too many long term changes at this time.

Our view is that we will only see significant change when the Government resolves the major dilemma posed by KiwiSaver, namely:

> *Why would an employee choose to join a locked-in to age 65 scheme, when they can join an employer-based superannuation scheme which will deliver them benefits when they leave their employer at any time, even if the employer-based scheme costs them slightly more.*

The only outcomes that we see to this dilemma which could be structured so as to not adversely impact on existing schemes, are either tax-incentivised saving or compulsory savings within KiwiSaver schemes.

Melville Jessup Weaver's role in the KiwiSaver marketplace

Once all the details are available we expect to be able to provide a complete solution, working with clients to select the best response for them to the legislation.

This will include selecting a provider (if required) and ensuring that appropriate systems are set up to automatically enrol new employees on 1 April 2007 and provide existing employees with the information they require.

Meanwhile we will continue to work with individual clients and prospective clients on better understanding KiwiSaver.

ABOUT MELVILLE JESSUP WEAVER

Melville Jessup Weaver is a New Zealand firm of consulting actuaries. The areas in which we provide advice include superannuation, employee benefits, life insurance, general insurance, health insurance, asset consulting, accident insurance and information technology. The firm was established in 1992 and has offices in Wellington and Auckland.

The firm is affiliated to Towers Perrin, a global professional services firm that helps organisations around the world optimise performance through effective people, risk and financial management. Towers Perrin has offices in 25 countries and the business covers human resources services, reinsurance and Tillinghast.

APPENDIX

Table 4 - Asset Allocations and Expected Returns

	Benchmark Asset Allocation	Gross Returns (% p.a.)		
			Capital	
Sector	%	Income	Gain	Total
NZ Shares				
- Active	7.5	5.8	4.5	10.3
- Passive	7.5	5.8	4.5	10.3
Overseas Shares				
- Active	12.5	3.0	7.3	10.3
- Passive	22.5	3.0	7.3	10.3
Property	5.0	5.8	2.5	8.3
Alternative	5.0	3.0	7.3	10.3
Total Growth Assets	60.0			
NZ Fixed Interest	17.5	6.5	0.0	6.5
Overseas Fixed Interest	15.5	6.8	0.0	6.8
Cash	7.0	5.8	0.0	5.8
Total Income Assets	40.0			
Total	100.0			

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