Inland Revenue
Te Tari Taake

POLICY ADVICE DIVISION

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Enhanced KiwiSaver package - detailed design

Date:	30 March 2007	**Priority:**	**High**
Security Level:		**Report No:**	T2007/467 PAD2007/078

Action sought

	Action Sought	**Deadline**
Minister of Finance	Agree to recommendations	3 April 2007
Minister of Revenue	Agree to recommendations	3 April 2007

Contact for telephone discussion (if required)

Name	**Position**	**Telephone**
Michael Nutsford	Policy Manager, Inland Revenue	*[information deleted in order to protect the privacy of natural persons, including deceased people]*
Peter Martin	Director, Economic Performance Group, the Treasury	

30 March 2007

Minister of Finance
Minister of Revenue

Enhanced KiwiSaver package - detailed design

Executive summary

This report outlines officials' recommendations on detailed design parameters of the enhanced KiwiSaver package proposals. In making recommendations, officials have had regard to the overall policy intent of KiwiSaver, which is to encourage a long term savings habit and asset accumulation by individuals who are not in a position to enjoy standards of living similar to those in pre-retirement.

Two of the key policy design issues are who the changes should apply to and how the member tax credit and compulsory employer contributions should be treated under the KiwiSaver withdrawal facilities. The main recommendations are summarised in the following tables:

	Eligibility	
	Member tax credit	**Compulsory employer contributions**
Employees		
< 18 years	x	x
18 years – age of eligibility for withdrawal	✓	✓
> age of eligibility for withdrawal	x	x
Self-employed		
< 18 years	x	x
18 years – age of eligibility for withdrawal	✓	x
> age of eligibility for withdrawal	x	x
ACC or PPL recipient	✓	x
All others (includes beneficiaries)		
< 18 years	x	x
18 years – age of eligibility for withdrawal	✓	x
> age of eligibility for withdrawal	x	x
Members whose principal place of residence is overseas	x	x

Withdrawal type	KiwiSaver	Ability to withdraw under enhanced KiwiSaver package	
		Member tax credit	Compulsory employer contributions
Mortgage diversion	Employee contributions	x	x
First home ownership	Employee + employer contributions	x	✓
Significant financial hardship	Employee + employer contributions	x	✓
Serious illness	All funds in KiwiSaver account	✓	✓
Permanent emigration	All funds in KiwiSaver account	Clawed back	✓
Death	All funds in KiwiSaver account	✓	✓
Age of eligibility for NZS or five years of membership	All funds in KiwiSaver account	✓	✓

The report recommends that if an employer fails to meet their compulsory employer contribution obligations, the government guarantee such contributions up to $20 per week per employee (the value of the employer tax credit).

In terms of implementation, the report discusses proposals for Inland Revenue to:

- not be required to collect contributions to non-KiwiSaver schemes in the short-term (providers would identify when employers fail to make compulsory employer contributions to such schemes and then follow a process to ensure such short payments are recovered);
- collect all employer contributions to KiwiSaver schemes, which will allow the department to identify when employers fail to meet their compulsory employer contribution obligations;
- act as a central agency for recovering all short paid compulsory employer contributions, and imposing and collecting penalties on short payments, *[information deleted as disclosure would prejudice the maintenance of the law]*
- on-pay government payments for short paid employer contributions to providers; and
- investigate in the future the possibility of all contributions (to KiwiSaver schemes and complying funds) being paid via Inland Revenue.

This report also proposes to make a change to the original design of KiwiSaver in view of the increased funding by the government. The ability to have employer contributions counting towards the contribution rate will no longer apply from 1 April 2008. Where an existing arrangement of employer contributions counting towards the contribution rate is in place, the ability for this to occur will be phased out. Recommendations are also made in relation to a number of other technical detailed design parameters.

Recommended action

It is recommended that you:

Who should the changes apply to?

(a) **Agree** that compulsory employer contributions apply if the employer is required to deduct KiwiSaver contributions from an employee's salary or wages or deduct complying fund superannuation contributions from an employee's salary or wages (as defined in the KiwiSaver Act).

Agreed / Not agreed Agreed / Not agreed

(b) **Agree** that compulsory employer contributions not apply in respect of contributions deducted from paid parental leave (paid by Inland Revenue) or weekly ACC compensation.

Agreed / Not agreed Agreed / Not agreed

(c) **Agree** that eligibility for the member tax credit not be restricted to those that derive "active income" because it would add complexity for little gain.

Agreed / Not agreed Agreed / Not agreed

If you do not agree with recommendation (c):

(c)(i) **Agree** that the member tax credit apply to persons who derive the following income types:

- salary or wages;
- income from a business; and
- shareholder-employee salary not subject to PAYE.

Agreed / Not agreed Agreed / Not agreed

and:
(c)(ii) **Agree** that the member tax credit apply in respect of contributions made by the self-employed even if they have a loss from business activities.

Agreed / Not agreed Agreed / Not agreed

(d) **Agree** that eligibility for the member tax credit and compulsory employer contributions be restricted to those aged 18 years and older.

Agreed / Not agreed Agreed / Not agreed

(e) **Note** that restricting the member tax credit and compulsory employer contributions to those aged 18 years and older will create an inconsistency with the Bill of Rights Act, but officials understand the scope for disadvantage to be limited.

(f) **Agree** that the member tax credit and compulsory employer contributions not apply in respect of members who have reached the age of eligibility for withdrawal (New Zealand Superannuation qualification age or five years of membership, whichever is later).

Agreed / Not agreed Agreed / Not agreed

(g) **Agree** that the employer tax credit apply only in respect of employer contributions on behalf of those employees for whom employer contributions are compulsory (ie in respect of employer contributions on behalf of those aged between 18 years and the age of eligibility for withdrawal).

Agreed / Not agreed Agreed / Not agreed

(h) **Agree** that the member tax credit applies only to people:

either

i. who are tax resident in New Zealand

Agreed / Not agreed Agreed / Not agreed

or (officials' preferred option)

ii. whose principal place of residence is in New Zealand.

Agreed / Not agreed Agreed / Not agreed

(i) **Agree** that member the tax credit not apply to people living overseas even if they earn income in New Zealand.

Agreed / Not agreed Agreed / Not agreed

(j) **Agree** that government employees living overseas be entitled to receive the member tax credit.

Agreed / Not agreed Agreed / Not agreed

(k) **Agree** that people volunteering or working for token payment overseas for a charitable organisation be entitled to receive the member tax credit and that the same criteria apply as for the charitable organisation interest-free student loan exemption.

Agreed / Not agreed Agreed / Not agreed

(l) **Agree** that compulsory employer contributions and the employer tax credit only apply in respect of employers who are tax resident in New Zealand or carry on business from a fixed establishment in New Zealand.

Agreed / Not agreed Agreed / Not agreed

How should the member tax credit and compulsory employer contributions be treated under the KiwiSaver withdrawal facilities?

(m) **Agree** that contributions diverted under the mortgage diversion facility not count towards eligibility for the member tax credit, and that the member tax credit and compulsory employer contributions not be able to be diverted towards repayment of a mortgage.

Agreed / Not agreed Agreed / Not agreed

(n) **Agree** that the member tax credit not be able to be withdrawn under the first home ownership withdrawal facility, but that compulsory employer contributions are able to be withdrawn under the facility.

Agreed / Not agreed Agreed / Not agreed

(o) **Agree** that the member tax credit not be able to be withdrawn under the significant financial hardship withdrawal facility, but that compulsory employer contributions are able to be withdrawn under the facility.

Agreed / Not agreed Agreed / Not agreed

(p) **Agree** that both the member tax credit and compulsory employer contributions be able to be withdrawn under the serious illness withdrawal facility.

Agreed / Not agreed Agreed / Not agreed

(q) **Agree** that, if a member uses the permanent emigration withdrawal facility, the nominal value of the member tax credit in their KiwiSaver account be clawed back (up to the value of the funds in the account) and that compulsory employer contributions are able to be withdrawn under the facility.

Agreed / Not agreed Agreed / Not agreed

(r) **Agree** that both the member tax credit and compulsory employer contributions be paid to a member's estate upon death.

Agreed / Not agreed Agreed / Not agreed

(s) **Agree** that when a member reaches the age of eligibility for withdrawal both the member tax credit and compulsory employer contributions be able to be withdrawn.

Agreed / Not agreed Agreed / Not agreed

(t) **Agree** that people who are entitled to receive New Zealand Superannuation as a non-qualifying partner not be able to withdraw their KiwiSaver funds.

Agreed / Not agreed Agreed / Not agreed

Should compulsory employer contributions by guaranteed by the government?

(u) **Agree** to one of the following:
either
i. no government payment of short paid compulsory employer contributions.

Agreed / Not agreed Agreed / Not agreed

or (officials' preferred option)
ii. government payment of short paid compulsory employer contributions up to $20 per week (the value of the employer tax credit).

Agreed / Not agreed Agreed / Not agreed

or
iii. full government payment of short paid compulsory employer contributions.

Agreed / Not agreed Agreed / Not agreed

Ensuring that compulsory employer contributions are paid

(v) **Agree** that in the short-term Inland Revenue *not* collect contributions to *non-KiwiSaver* schemes (ie Inland Revenue would not act as a central collection mechanism for compulsory employer contributions).

Agreed / Not agreed Agreed / Not agreed

(w) **Note** that officials will report back to you on the feasibility of Inland Revenue acting as a central collection mechanism for compulsory employer contributions after canvassing the issue with existing scheme providers.

Noted Noted

(x) **Agree** that it be compulsory that *all* employer contributions to *KiwiSaver schemes* be paid via Inland Revenue.

Agreed / Not agreed Agreed / Not agreed

(y) **Agree** that Inland Revenue be required to check whether compulsory employer contributions to KiwiSaver schemes have been paid.

Agreed / Not agreed Agreed / Not agreed

(z) **Agree** that scheme providers be required to check whether compulsory employer contributions to non-KiwiSaver schemes have been paid.

Agreed / Not agreed   Agreed / Not agreed

(aa) **Agree** that Inland Revenue act as a central agency for recovering short-paid compulsory employer contributions (whether short-paid to a KiwiSaver scheme or to an existing scheme).

Agreed / Not agreed   Agreed / Not agreed

(bb) **Agree** that the following process applies for Inland Revenue to become aware of short paid employer contributions to an existing scheme:

- providers try to recover the short payment from the employer before informing the Government Actuary;
- the Government Actuary and the provider agree on the amount of the short payment;
- the Government Actuary write to the employer letting them know that the debt will be sent to Inland Revenue for recovery and that they have a certain number of days to dispute the amount; and
- the debt then be sent to Inland Revenue for recovery.

Agreed / Not agreed   Agreed / Not agreed

(cc) **Agree** that the existing penalties in the Tax Administration Act apply to short paid employer contributions.

Agreed / Not agreed   Agreed / Not agreed

Other detailed design issues

(dd) **Agree** that from 1 April 2008 employer contributions will no longer be able to count towards the employee's contribution rate and, where an existing arrangement is in place, the ability for employer contributions to count towards the employee's contribution rate be phased out.

Agreed / Not agreed   Agreed / Not agreed

(ee) **Agree** that employer contributions that count towards the compulsory amount be required to vest fully in the employee.

Agreed / Not agreed   Agreed / Not agreed

(ff) **Agree** that the employer tax credit be paid when employer contributions are paid.

Agreed / Not agreed   Agreed / Not agreed

(gg) **Agree** that the employer tax credit be claimed monthly by employers, leveraging off the employer monthly schedule process.

Agreed / Not agreed Agreed / Not agreed

(hh) **Agree** that trustees of schemes with fewer than 20 members be required to comply with certain investment restrictions, including:

- precluding lending money or providing goods or services from the fund to an associated person (a person associated with the trustee or a member) for an amount less than market value; and
- precluding the acquisition of goods and services from a person associated with the superannuation fund for an amount greater than market value.

Agreed / Not agreed Agreed / Not agreed

(ii) **Agree** that the employer be able to claim a tax deduction only in respect of employer contributions where there is not a corresponding tax credit and that the employer tax credit be treated as “excluded income”.

Agreed / Not agreed Agreed / Not agreed

(jj) **Agree** that it be clarified that the member tax credit be treated as “excluded income”.

Agreed / Not agreed Agreed / Not agreed

(kk) **Agree** that the government not pay interest on the member and employer tax credits.

Agreed / Not agreed Agreed / Not agreed

(ll) **Agree** that the member tax credit be the lesser of the member’s contribution or $1,040 a year (which equates to $20 per week).

Agreed / Not agreed Agreed / Not agreed

(mm) **Agree** that compulsory employer contributions be calculated on a payment basis (ie 4% of each payment of salary or wages the employee receives).

Agreed / Not agreed Agreed / Not agreed

(nn) **Agree** that the employer tax credit apply in respect of both voluntary and compulsory employer contributions.

Agreed / Not agreed Agreed / Not agreed

(oo) **Agree** that where a person has multiple employers each employer be able to claim a tax credit in respect of their contributions, provided they are not associated and that the tax credit is up to $20 per employee per week.

Agreed / Not agreed   Agreed / Not agreed

(pp) **Agree** that the penalty provisions in the Tax Administration Act apply where an employer claims a tax credit more than once in respect of the same employee.

Agreed / Not agreed   Agreed / Not agreed

(qq) **Note** that officials will report back to Ministers if there are concerns that employees are being discriminated against because they are KiwiSaver members.

Noted   Noted

(rr) **Agree** that Inland Revenue have the ability to claw back tax credits if, in any instance, a person is later found to be ineligible to receive them.

Agreed / Not agreed   Agreed / Not agreed

(ss) **Agree** that the member tax credit and compulsory employer contributions be applied on a pro rata basis across the investment products that the person has chosen and that the credit be applied to an account fully vested in the employee.

Agreed / Not agreed   Agreed / Not agreed

(tt) **Agree** that no time limit be imposed on claiming member tax credits and that, if the member tax credit is not used in full in any one year, the remainder cannot be used in a following year.

Agreed / Not agreed   Agreed / Not agreed

(uu) **Agree** that the GST (Grants and Subsidies) Order be amended to ensure that the member tax credit and employer tax credit are not subject to GST.

Agreed / Not agreed   Agreed / Not agreed

(vv) **Agree** that a person must be living, or normally living, in New Zealand to join KiwiSaver (with an exception for government employees living overseas).

Agreed / Not agreed   Agreed / Not agreed

Implementation

(ww) **Note** that Inland Revenue can deliver the member tax credit proposal from 1 July 2007 so long as it is based on the provider submitting an annual claim to Inland Revenue on behalf

of the member and that Inland Revenue will be able to check employee contributions to KiwiSaver schemes from 1 July 2007.

Noted Noted

(xx) *[information deleted as disclosure would prejudice the maintenance of the law*

]

Peter Martin
Director, Economic Performance Group
for Secretary to the Treasury

Mike Nutsford
Policy Manager
Inland Revenue

Hon Dr Michael Cullen
Minister of Finance

Hon Peter Dunne
Minister of Revenue

Background

1. This report outlines officials' recommendations on detailed parameters on the enhanced KiwiSaver proposals as outlined in the accompanying overview report ('Overview of the Enhanced KiwiSaver Package').

2. The report considers and recommends changes in relation to:
   (a) Main policy design issues
      i. Who should the changes apply to?
      ii. How should the member tax credit and compulsory employer contributions be treated under the KiwiSaver withdrawal facilities?
      iii. Should short paid compulsory employer contributions be paid by the government?
      iv. Ensuring that compulsory employer contributions are paid
   (b) Other detailed design issues
   (c) Implementation

Purpose of KiwiSaver

3. The purpose of KiwiSaver is to encourage a long-term savings habit and asset accumulation by individuals who are not in a position to enjoy standards of living in retirement similar to those in pre-retirement. KiwiSaver aims to increase individuals' well-being and financial independence, particularly in retirement, and to provide retirement benefits. In making recommendations on the detailed design parameters, officials have had regard to the overall policy intent of KiwiSaver.

(a) Main policy design issues

(i) Who should the changes apply to?

4. Officials do not consider that the proposed changes should alter who is eligible to join KiwiSaver (see Appendix for who is eligible to join). However, the issue of which KiwiSaver members and employers the proposed changes apply to needs to be considered.

Members

Employment status

5. In terms of the member tax credit, as a general rule officials see no policy reason to distinguish between people based on their employment status. That is, officials consider the member tax credit should be available to employees, the self-employed, beneficiaries etc.

6. The compulsory employer contributions would only apply in respect of employees. It would, by definition, not apply to the self-employed, shareholder employees whose salary or wages is not subject to PAYE and those who are not working. It is recommended that

compulsory employer contributions apply if an employer is required to deduct KiwiSaver contributions from an employee's salary or wages or deduct complying fund superannuation contributions from an employee's salary or wages (as defined in the KiwiSaver Act).

Paid parental leave and ACC

7. Inland Revenue and ACC are deemed to be the employer under the KiwiSaver Act in respect of paid parental leave (PPL) and weekly compensation payments. Having compulsory employer contributions apply in respect of contributions deducted from such payments would add complexity. However, it could be argued on equity grounds that compulsory employer contributions should apply in respect of contributions deducted from such payments given that they are generally a substitute for employment income.

8. On balance, it is recommended that compulsory employer contributions not apply in respect of PPL and ACC payments – this could always be reviewed at a later date if Ministers wished. PPL and ACC recipients would still be eligible for the member tax credit if deductions of contributions were made from their PPL or ACC payments.

Limiting member tax credit to persons who derive "active" income

9. You asked for options to ensure that the member tax credit applied only in respect of contributions made from "active" income (ie income that was in the nature of, or a close substitute for, employment income). This would stop, for example a high-income earning spouse making a contribution to the KiwiSaver account of a non-earning spouse and the non-earning spouse receiving a tax credit in respect of that contribution.

10. Officials consider that there should not be a requirement that a person must earn "active" income in order to receive the member tax credit as it would add considerable complexity for little gain. Contributions made on behalf of a person (and a member tax credit paid in respect of the contributions) would be in the person's own name and would be locked-in until they reach the age of eligibility for withdrawal. Arguably it would then be inequitable not to allow a person a member tax credit in respect of such contributions. Such a person may not be earning income but could be contributing to society in another way – for example, a stay at home mother.

11. If Ministers wished to proceed with restricting access to the member tax credit, officials consider that it should apply to persons who derive the following income types:

- salary or wages (this would also allow beneficiary and ACC recipients to receive the tax credit);
- income from a business (includes partnership income); and
- shareholder-employee salary not subject to PAYE.

12. Officials consider that member tax credit should apply in respect of contributions made by the self-employed even if they have a loss from business activities.

13. The above rules could potentially be easy to circumvent – for example, a non-earning spouse could make an investment in a business as a non-active partner, or become an employee of the spouse's business, and therefore be eligible for the tax credit. It would also increase the administration costs for Inland Revenue as a further check would need to be done before the member tax credit could be paid.

Age

Member tax credit

Lower age limit

14. Currently children are able to join KiwiSaver but the automatic enrolment rules do not apply until a person is 18 years or older. If no age restriction is set on accessing the member tax credit parents will have an incentive to set up a KiwiSaver account for their children predominantly to benefit from the tax credit.[1] This will benefit high-income earners more as they are more likely to be in a position to set aside money for their children rather than spend it on essentials (such as education). Providing the member tax credit in respect of children could have a large fiscal cost.

15. On the other hand, as KiwiSaver is designed to encourage a long-term savings habit it could be considered inequitable to restrict access to the member tax credit based on age. Furthermore, having a low (or no) age restriction would support the introduction of a savings discipline early in life. It would also help to ensure that people are exposed early on in life in relation to the concept of retirement income adequacy.

16. A cut-off of 18 years would be consistent with the automatic enrolment rules – having another rule would add complexity. While 16 and 17 year olds are legally able to work full-time and are eligible for certain benefits (such as the community services card and the independent youth benefit), setting the cut-off at 18 would be consistent with the government's preference that 16 and 17 year olds be engaged in some form of study, as opposed to working. However, it could be considered inequitable that those who are legally able to work and who want to save for their retirement are not able to access the same benefits as those who are older. In any case, this is largely transitional – as soon as the person turns 18 they would become entitled to the member tax credit.

17. On balance, officials recommend that the member tax credit not be available to those aged under 18 years. This will create an inconsistency with the Bill of Rights Act. Officials have had preliminary discussions with the Ministry of Justice on the implications and understand the scope of the disadvantage to be limited.

Upper age limit

18. The question arises as to whether the member tax credit should also cease at the same time eligibility for the fee subsidy ceases - that is, once a member has reached the age of

[1] Parents could put $20 per week into the account n order to receive the member tax credit of $20 per week.

eligibility for withdrawal (ie eligibility for New Zealand Superannuation (NZS) or five years of membership, whichever is later). If there was no upper limit on eligibility for the member tax credit, there would be an incentive for members to contribute $20 per week for the rest of their life in order to obtain the matching government contribution and then simply draw it out again. It could also be considered inequitable that those who have reached the age of eligibility for NZS – ie who have reached the age at which society treats them as 'retired' and who receive a government pension because of it – continue to benefit from a government policy aimed at retirement savings.

19. On the other hand, it could be perceived as inequitable that those who continue to work and save for their retirement are unable to receive the tax credit. Arguably not providing the member tax credit to such people is inconsistent with the New Zealand Positive Ageing Strategy, which seeks to support the employment of older workers.

20. On balance, as those that have reached the age of eligibility for withdrawal will be able to receive NZS (regardless of their income), and because it is consistent with the original policy intent of KiwiSaver (ie to provide retirement benefits), it is considered appropriate that the member tax credit should cease at the same time they are eligible to withdraw their funds (the same time as eligibility for the fee subsidy ceases).

Compulsory employer contributions and employer tax credit

To be consistent with the recommendations regarding the member tax credit, officials consider:

- compulsory employer contributions should apply only in respect of those employees who are eligible for the member tax credit (ie employees aged between 18 years and the age of eligibility for withdrawal).
- the employer tax credit only be available in respect of employer contributions on behalf of those employees for whom employer contributions are compulsory (ie in respect of employees aged between 18 years and the age of eligibility for withdrawal).[2]

21. Arguably a cut-off of 18 years will place an incentive on employers to hire those aged under 18 so as to avoid paying compulsory contributions. Officials will report back to Ministers if there are concerns that this may be the case.

22. The pros and cons of the proposals are summarised in the following table:

Proposal	**Pros**	**Cons**
People aged < 18 years can't access member tax credit or compulsory employer contributions	Limits fiscal cost. Reduces the risk that high income families will make arrangements to	Could be perceived as inequitable that those establishing a savings habit can't access member tax credit or compulsory employer contributions.

[2] This would stop, for example, parents employing their children aged less than 18 years, paying an employer contribution of $20 per week and claiming an employer tax credit of $20 per week.

	benefit from tax credits.	
People who have reached the age of eligibility for withdrawal can't access member tax credit or compulsory employer contributions	Limits fiscal cost. Such people already receive NZS – inequitable to provide them with a further government benefit.	Could be perceived as inequitable that those continuing to work and save for their retirement cannot access member tax credit or compulsory employer contributions. Arguably inconsistent with other government policy which seeks to support employment of older people.

Members living overseas

Member tax credit

23. Currently, KiwiSaver members who go overseas can continue to contribute and will receive the fee subsidy while they are overseas. If the member tax credit was available to people living overseas, there will be an incentive for such people to make contributions to KiwiSaver, which could have a significant fiscal cost. You have asked for options to restrict the access to member tax credit for those living overseas – the default being that if a person is living offshore they do not receive the tax credit.

Option one – member tax credit applies only to those tax resident in New Zealand

24. Under this option access to the member tax credit would be restricted to those who are tax resident in New Zealand. There are two main problems with using tax residency. First, Inland Revenue often does not know that a person has ceased to be resident in New Zealand – people tend to leave the country without informing Inland Revenue and continue to show in the system as resident (with nil income). This problem has been experienced most notably with student loan borrowers. The second problem is that it is very easy to remain tax resident (tax residence is designed so that it is easy to gain but difficult to lose). A person could be tax resident by virtue of retaining the family home[3] and therefore receive the member tax credit, yet for all intent and purpose be living permanently overseas. New Zealand may not even retain taxing rights over most of their income as a double tax agreement tie breaker could allocate such rights to the overseas country in which they are living. Therefore, this option is not recommended.

Option two – member tax credit applies only to those whose principal place of residence is in New Zealand (officials' preferred option)

25. The second option is for the member tax credit to apply only to those people whose principal place of residence is in New Zealand. This would mean that those who were temporarily overseas (such as on holiday or on a short term work secondment) would continue to be entitled to the member tax credit while they were away. Those who moved

[3] And deemed to have a permanent place of abode in New Zealand as a result.

permanently overseas would not qualify for the tax credit (even if they retain tax residence in New Zealand, for example by virtue of retaining the family home).

26. This test is similar to the concept of residency for student loans purposes in which a person is generally considered non-resident if they have been overseas for more than six months (effectively meaning that those whose principal place of residence is overseas will be considered non-resident). The student loans test is based on a day count, which works well because of the data match that will occur between Inland Revenue and the New Zealand Customs Service. Officials consider that a day count would be more administratively complex for providers than the principal place of residence test proposed.

27. For a scheme to claim a tax credit for a member, the trustees would have to be reasonably satisfied that the person's principal place of residence was not in another country. Officials consider that a member should be required to inform the trustee of a scheme if their principal place of residence is overseas – if the trustee is not so informed, they would be considered to have met the test. Trustees would need to remind members of the obligation to inform the scheme if they move overseas.

28. There is a risk that members will move overseas and will not inform providers. It is therefore recommended that upon application for a withdrawal a member be required to sign a statutory declaration stating if they ever had a principal place of residence overseas. The member tax credit could then be clawed back if they had received it for a period for which they were not entitled. If they made a false declaration, existing criminal law would apply.

Exemptions

29. The question arises as to whether people whose principal place of residence is overseas should be entitled to the member tax credit if they are earning income in New Zealand. Officials consider that this would open up opportunities for abuse. As noted above, New Zealand may not even have taxing rights in respect of the income earned in New Zealand because of the residency tie-breaker tests under New Zealand's double tax agreements. It is therefore recommended that the member tax credit not apply if someone's principal place of residence is overseas, regardless of whether they earn income in New Zealand. If Ministers did want the tax credit to apply in such situations, officials consider that it should only apply in respect of contributions from "active income". Even then, an active income test could potentially be circumvented.

30. Officials consider that an exception should apply in the case of government employees living overseas – that is, government employees living overseas should be able to access the member tax credit. This is consistent with other government policy, for example interest-free student loans for government employees living overseas.

31. Allowing the member tax credit to apply in respect of contributions made by people working overseas for charitable organisations would be consistent with other government policy, such as interest-free student loans for those volunteering or working for token payment overseas for a charitable organisation listed in regulations. Officials recommend that eligibility for the member tax credit on the basis of the charitable work be the same as that

applying for student loans, namely that they are volunteering or working for token payment. An organisation would be listed in regulations if it meets the criteria for being granted donee status. The member would have to provide proof to the scheme provider that they met the criteria for eligibility in order for the provider to make a claim for the tax credit on their behalf.

Employers

32. Officials consider that the compulsory employer contributions and the employer tax credit should apply only in respect of the employers that the KiwiSaver Act applies to (see Appendix for details).

Summary of recommendations for who the changes should apply to

33. The table below summarises officials' recommendations in respect of who is eligible for the member tax credit and who compulsory employer contributions should apply to:

	Eligibility	
	Member tax credit	**Compulsory employer contributions**
Employees		
< 18 years	x	x
18 years – age of eligibility for withdrawal	✓	✓
> age of eligibility for withdrawal	x	x
Self-employed		
< 18 years	x	x
18 years – age of eligibility for withdrawal	✓	x
> age of eligibility for withdrawal	x	x
ACC or PPL recipient	✓	x
All others (includes beneficiaries)		
< 18 years	x	x
18 years – age of eligibility for withdrawal	✓	x
> age of eligibility for withdrawal	x	x
Members whose principal place of residence is overseas	x	x

(ii) How should the member tax credit and compulsory employer contributions be treated under the KiwiSaver withdrawal facilities?

34. Members are able to withdraw their funds from their KiwiSaver scheme in specified circumstances. The withdrawals are generally administered by the trustees of the member's scheme. Inland Revenue only administers withdrawals in relation to initial contributions in

the Inland Revenue holding account (initial contributions are held for three months).[4] The appendix discusses the withdrawal facilities.

Mortgage diversion

Member tax credit

35. The question arises as to whether contributions diverted should count towards eligibility for the member tax credit, and whether the tax credit itself should be able to be diverted towards repayment of a person's mortgage. If this was able to occur the government would, in effect, be providing a subsidy for mortgage repayments. Given that the purpose of the member tax credit is to directly encourage retirement savings, officials consider that contributions diverted should not count towards eligibility for the member tax credit, and that the credit should not be able to be diverted towards repayment of a mortgage. The effect of this is that a member earning under $52,000 per year and who used the mortgage diversion facility would need to contribute 8% of their income to KiwiSaver to obtain the maximum member tax credit.[5]

Compulsory employer contributions

36. Officials do not consider there are policy reasons for the introduction of compulsory employer contributions to change the rule that employer contributions cannot be diverted.

First home ownership

Member tax credit

37. The question arises as to whether to allow the member tax credit to be withdrawn under the first home ownership withdrawal facility. If it were able to be withdrawn, the government would, in effect, be providing a subsidy for first home ownership (in addition to that already provided to those KiwiSaver members who meet the requisite criteria). Officials consider that if the government wished to provide access to a housing subsidy for a larger number of people, or wanted to increase the level of the current subsidy, it should re-visit the housing subsidy criteria and level, as opposed to subsidising housing indirectly.

38. If the member tax credit was unable to be withdrawn, it would help to reduce the risk of providers dealing with a large number of accounts with small balances.

39. For the reasons outlined above, officials consider that the member tax credit should not be able to be withdrawn under the first home ownership withdrawal facility.

Compulsory employer contributions

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[4] The only withdrawals that can be made from the holding account are if the person is suffering, or likely to suffer, significant financial hardship or is suffering serious illness.

[5] The maximum value that an employee can divert is half of their own contribution. If a member earned $52,000 per annum and contributed 4% of their income, the maximum amount they could divert towards mortgage repayments would be $1,040. A further $1,040 would be saved, allowing them to get the full tax credit. Employees who earn less than $52,000 per year would need to contribute at 8% to get the maximum tax credit.

40. Officials do not consider that the introduction of compulsory employer contributions alters whether employer contributions should/should not be able to be withdrawn under the first home ownership facility. Given that research has shown that quickly over time (over 10 years) up to 70 per cent of the cost of compulsory contributions would be borne by the employee in the form of wage adjustments, the majority of employer contributions are effectively contributions made by the employee themselves (as a result of a reduced wage). Officials consider that it would be punitive to not allow such contributions to be withdrawn under the first home ownership withdrawal facility. It would also be contrary to the intent of the withdrawal facility under KiwiSaver as it was originally enacted.

Significant financial hardship

Member tax credit

41. The question arises as to whether the member tax credit should be able to be withdrawn in cases of significant financial hardship. As the focus of the member tax credit is to encourage and help individuals with their retirement savings, officials consider that the member tax credit should not be able to be withdrawn in such cases.

42. Although the length of a financial hardship may vary from individual to individual, it is largely a circumstantial occurrence in one's life. Members are also able to take a contributions holiday after 12 months for any reason (if they are suffering financial hardship prior to then they can also be granted a contributions holiday). The combination of being able to access their contributions under the significant financial hardship withdrawal and the contributions holiday mechanism should provide members with some financial relief in times of hardship, whilst ensuring that they still have a retirement savings base.

Compulsory employer contributions

43. Officials do not see any reason why the proposed changes should alter the ability for employer contributions to be withdrawn under this withdrawal facility. Again, if the majority of employer contributions are effectively contributions made by the employee themselves (in the form of a reduced wage) officials consider it would be punitive not to allow employer contributions to be withdrawn.

Serious illness

Member tax credit and compulsory employer contributions

44. The question arises as to whether to allow the member tax credit and compulsory employer contributions to be withdrawn in cases of serious illness. After the changes to the definition of "serious illness" agreed to by Cabinet are made (see appendix for details), the withdrawal facility should only apply in cases where the member is unable to engage in work on a long-term basis. Therefore, the likelihood of that person being able to work again and save for their retirement is low. Accordingly, officials see no reason for not allowing the member tax credit and compulsory employer contributions to be withdrawn.

Permanent emigration

Member tax credit

45. You are asked to agree that the full nominal amount of the member tax credit be clawed back if the permanent emigration withdrawal facility is utilised. The amount clawed would be no more than the value of the funds in the member's account. The advantages of clawing back the member tax credit are: it would reduce the fiscal cost of the proposal; it encourages people to stay in New Zealand; helps to ensure that the member tax credit does not subsidise consumption (which it could do if it was able to be withdrawn); and is equitable for those who stay in New Zealand and cannot access the tax credits. The disadvantages of the option are that it is potentially complex to communicate and administer, and it could be considered inequitable for those who have genuinely been saving. Depending on the value of the credit clawed back, the likely consequence of this option is that members would leave their funds in the scheme until reaching the age of eligibility for withdrawal.

46. Once complete, the work on the portability of retirement savings should enable transfers to Australian superannuation schemes with similar lock-in rules to KiwiSaver. Enabling the member tax credit to be transferred would mean that the concern of it subsidising consumption would no longer apply.

Compulsory employer contributions

47. The question arises as to whether compulsory employer contributions should be able to be withdrawn when a KiwiSaver member permanently emigrates. Arguably granting access to compulsory employer contributions upon permanent emigration from New Zealand may create an incentive for people to emigrate in order to gain access to those contributions. However, officials consider the risk of this occurring to be low. If compulsory employer contributions were unable to be withdrawn, there is an incentive for members to leave their funds in the scheme until reaching the age of eligibility for withdrawal (which have a flow on effect in that the fee subsidy would continue to be paid in respect of such people).[6] It could also be considered inequitable not to allow employer contributions to be withdrawn given that there may have been wage adjustments because of them.

48. On balance it is recommended that members who utilise the permanent emigration withdrawal facility be able to withdraw their compulsory employer contributions.

Death

49. Officials consider that both the member tax credit and the compulsory employer contributions should be paid to the member's estate upon death, in line with current policy.

Age of eligibility for withdrawal

50. Officials recommend that the member tax credit and compulsory employer contributions be locked in until the age of eligibility for withdrawal, which maintains the

[6] People living overseas are currently entitled to receive the fee subsidy. If the person left their funds in the scheme while living overseas there would be a fiscal cost in relation to paying the ongoing fee subsidy.

focus on retirement (as it is linked to eligibility for NZS). That is, they are able (but not required) to be withdrawn at this age.

Summary of recommendations for how the member tax credit and compulsory employer contributions should be treated under the KiwiSaver withdrawal facilities

51. The table below summarises officials' recommendations in respect of whether the member tax credit and compulsory employer contributions should be able to be withdrawn under each of the withdrawal facilities:

Withdrawal type	**KiwiSaver**	**Ability to withdraw under enhanced KiwiSaver package**	
		Member tax credit	**Compulsory employer contributions**
Mortgage diversion	Employee contributions	x	x
First home ownership	Employee + employer contributions	x	✓
Significant financial hardship	Employee + employer contributions	x	✓
Serious illness	All funds in KiwiSaver account[7]	✓	✓
Permanent emigration	All funds in KiwiSaver account	Clawed back	✓
Death	All funds in KiwiSaver account	✓	✓
Age of eligibility for NZS or five years of membership	All funds in KiwiSaver account	✓	✓

NZS non-qualifying partners

52. The Minister of Finance has raised the issue of whether a person entitled to receive NZS as a non-qualifying partner should be able to withdraw the funds in their KiwiSaver scheme.[8]

53. It could be seen as inconsistent that the government effectively treats someone as 'retired' on the one hand (in terms of eligibility for NZS) but on the other hand the same person is not treated as being 'retired' (in terms of eligibility for a KiwiSaver withdrawal). The question therefore arises as to whether non-qualifying partners should be entitled to access their KiwiSaver funds by virtue of the qualifying partner reaching the age of entitlement for withdrawal.

54. If such a withdrawal was permitted there may be a number of implications on the non-qualifying spouse's ability to access NZS. From the date the non-qualifying partner became able to withdraw their funds, whether or not they were actually withdrawn, any income on the funds in their KiwiSaver account (for example, interest income) would affect their NZS payments. The clear incentive would therefore be for the non-qualifying spouse to consume the whole of the amount in their KiwiSaver account immediately to preserve their existing non-qualifying spouse NZS entitlement. This would not to do a lot for retirement provision, unless the funds were used to retire debt. Furthermore, the introduction of access to KiwiSaver funds for non-qualifying NZS partners may lead to people applying to receive non-qualifying partner payments under NZS purely so that they could withdraw the balance in

[7] After the legislative change referred to in paragraph 44 is enacted.
[8] If a person is entitled to NZS by virtue of having reached the age of entitlement (65 years) and has a partner who does not qualify for NZS (ie because the partner is younger than 65), the non-qualifying partner is entitled to be included in the qualifying partner's superannuation payments. The income of both is taken into account in determining the payment made to the non-qualifying partner.

their KiwiSaver account. The person may then revert to the original situation (ie of not receiving NZS) at an additional administrative cost to Work and Income.

55. Granting access to non-qualifying partners may also create equity issues. For example, if there was one couple made up of a 65 year old and a 60 year old, both partners could be entitled to access their KiwiSaver funds. However, another couple that consists of two 60 year olds would not be entitled to access their KiwiSaver funds. The second couple may feel that it is inequitable that the lack of having an older partner means that they are unable to withdraw their funds. In addition, further complexities are added if the non-qualifying partner splits up with the qualifying partner or if the qualifying partner dies prior to the non-qualifying partner reaching the age of eligibility for NZS.[9] For example, would the person need to pay back the value of the member tax credit that was withdrawn and it then be locked in until the person reaches NZS qualification age; and should the person be required to re-join KiwiSaver?

56. Because of the reasons outlined above, officials do not consider that a person should be able to withdraw their funds because of becoming eligible for NZS as a non-qualifying partner.

(iii) Should short paid compulsory employer contributions be paid by the government?

57. Employee contributions to KiwiSaver schemes are paid by the government (up to 8% of the employee's salary or wages). If the employer deducts KiwiSaver contributions from an employee's salary but fails to on-pay them, Inland Revenue makes good the payment and chases the employer for the short-payment.

58. The introduction of compulsory employer contributions raises the question of whether such short paid contributions should be paid by the government. There are three options which should be considered:

- Option one – no government payment of compulsory employer contributions
- Option two – government payment of compulsory employer contributions up to $20 per week (the amount of the employer tax credit) (officials' preferred option)
- Option three – full government payment of employer contributions

59. Giving a full government payment on employer contributions increases the likelihood that KiwiSaver will be perceived as a government guaranteed investment, which it is not. Furthermore, providing a government payment creates a potential presentation issue in that the compulsory employer contribution could be seen as not an employer contribution but a government contribution, in that if the employer does not pay it the government will.

60. However, if the majority of employer contributions are contributions effectively made by the employee themselves (in the form of a reduced wage), it could be argued that there is

[9] If the qualifying partner dies prior to the non-qualifying partner reaching the age of eligibility for NZS the non-qualifying partner loses eligibility for NZS and the other benefits are available to them (for example, the widow's benefit).

an inconsistency with the treatment of short-paid employee contributions if there is no government payment of employer contributions.

61. Option two provides a government payment of up to $20 per week (up to the maximum value of the employer tax credit). This would mean the government was making good the short paid employer contribution to the extent that it was prepared to give a credit for that contribution. In year one, this would effectively be a full government payment on employer contributions for employees earning $104,000 or less per year, so it is unlikely that employers will fall short on their employer contributions in the first year. Once compulsory employer contributions were fully phased in, it would be a full government payment for those employees earning $26,000 per year or less. Option two is officials' preferred option – it pays short-paid employer contributions to the degree of the government's contribution and reduces the risk of KiwiSaver incorrectly being perceived as government guaranteed. It would mean over time money will be owed to the government to the extent that employers fall short on their compulsory employer contributions.

(iv) Ensuring that compulsory employer contributions are paid

62. Currently the onus for ensuring KiwiSaver employer contributions are paid is on scheme providers. The KiwiSaver employee contribution rates have been implied into all scheme trust deeds. Trustees of the schemes therefore have a responsibility to ensure that employer contributions to schemes are made in accordance with the terms of the trust deed, although providers are able to assume that the contributions Inland Revenue sends them are correct.[10] If an employer contribution is shown on the employer monthly schedule and not fully paid, Inland Revenue will pass that information on to the provider. Because employer contributions are currently voluntary, any short payment is not treated as a tax debt and Inland Revenue does not impose penalties. The consequence of an employer not paying an employer contribution depends on the contract between the provider and the employer.

63. The introduction of compulsory employer contributions raises the question of who should have the policing role to ensure that such contributions have been paid.

Should Inland Revenue be required to collect contributions to non-KiwiSaver schemes (ie act as a central collection mechanism for compulsory employer contributions)?

64. The question arises as to whether Inland Revenue should collect contributions to non-KiwiSaver schemes, effectively acting as a central collection mechanism for all compulsory employer contributions. The rationale behind this approach is that leveraging off an existing system will provide a mechanism to ensure employers meet their obligations.

65. Currently it is optional for employer contributions to KiwiSaver schemes to be paid via Inland Revenue. Given that employers are not yet contributing to KiwiSaver schemes (ie employers have not established existing systems to contribute direct to scheme providers), officials consider that it would be feasible to require all employer contributions to KiwiSaver

[10] Only employer contributions that count towards the contribution rate of 4% or 8% specifically fall within this. However, if employer contributions are made to a scheme then there will generally be a contract between the provider and the employer for those employer contributions. If this is the case, the trustees will have a similar obligation to ensure that employer contributions that form part of the contract are paid.

schemes to come via Inland Revenue (ie make it compulsory). The compliance costs of this should be minimal as employers are required to send employee contributions via Inland Revenue and all employers have a relationship with the department.

66. Currently contributions to existing schemes cannot be paid via Inland Revenue. Introducing a requirement that this occur would have significant administration and compliance costs and could not be implemented in the short-term.

67. Employers who offer access to an existing scheme already have processes in place for contributing to those schemes. Requiring contributions to be paid via Inland Revenue would impose compliance costs on them. Other problems with requiring employer contributions to come via Inland Revenue include:

- Existing schemes don't currently deal with Inland Revenue. Requiring them to establish an electronic interface with Inland Revenue would potentially have significant compliance costs (with little or no perceived benefit to existing schemes and members). However, there are potentially flow on benefits for schemes in having a centralised administration agency.
- Would alter the cashflow of schemes in terms of a delay in payments reaching providers. Currently many providers receive contributions weekly or fortnightly – this would change to monthly (or longer than monthly) if contributions came via Inland Revenue.
- Some businesses provide a service for paying contributions to providers. Requiring contributions to come via Inland Revenue could potentially eliminate the demand for their services. However, officials understand that many of the firms currently offering these services are winding up this particular aspect of their business.

68. Given the difficulties outlined above, officials recommend that in the short-term contributions to existing schemes not be able to be paid via Inland Revenue. After canvassing the issue with existing scheme providers, officials will report back on whether it is a feasible option to require all contributions to be made via Inland Revenue. Officials further recommend that it be compulsory that employer contributions to KiwiSaver schemes be paid via Inland Revenue. This will enable Inland Revenue to have complete information about contributions to KiwiSaver schemes to identify when a compulsory employer contribution to a KiwiSaver scheme is short paid.

Checking that compulsory employer contributions are paid

69. The introduction of compulsory employer contributions means that a checking mechanism would need to be put in place to ensure that employers meet their obligations.

KiwiSaver schemes

70. Officials consider that Inland Revenue should check whether the employer contributions received are correct given that it has income information – requiring all

employer contributions to come via Inland Revenue will assist this checking process. This will be a new role for Inland Revenue.[11]

Existing schemes

71. Officials understand that providers typically have income information in relation to existing scheme members, meaning that they are able to check that employer contributions have been made in accordance with the contract. If there is a short payment, the provider contacts the employer to follow up on the short payment. Officials understand that this checking is usually done on a payment basis.

72. The introduction of compulsory employer contributions raises the question of who should check that the employer contributions received are correct. Given that employer contributions to existing schemes will continue to be paid direct to providers in the short term, officials consider that it is appropriate that providers do the checking in respect of contributions to existing schemes while this continues.

Recovering short paid employer contributions

73. Officials' initial view is that Inland Revenue should act as a central agency for recovering short paid employer contributions (whether short paid to a KiwiSaver scheme or to an existing scheme) and imposing and collecting penalties on short payments.

74. Inland Revenue would have information about short payments to KiwiSaver schemes. For Inland Revenue to become aware of a short payment to an existing scheme, it is recommended that the following process apply:

- the provider try to recover the short payment from the employer before informing the Government Actuary (these requirements are yet to be worked through). If the provider failed to do this the Government Actuary could impose penalties under the existing regulatory arrangements;
- the Government Actuary and the provider agree on the amount of the short payment;
- the Government Actuary writes to the employer letting them know that the debt would be sent to Inland Revenue for recovery and that they have a certain number of days to dispute the amount;
- the debt is sent to Inland Revenue for recovery.

75. This process would be similar to that for student loans – Inland Revenue receives a 'clean debt' from StudyLink (the debt is established and sent to Inland Revenue; Inland Revenue does not deal with disputes over the amount of the debt), and then collects it.

76. Officials recommend that the existing penalties in the Tax Administration Act apply to short paid employer contributions.

[11] Because employer contributions are currently voluntary, Inland Revenue systems do not check that employer contributions are actually made.

(b) Other detailed design issues

Employer contributions counting towards the minimum contribution rate

77. The KiwiSaver Act provides for employees to contribute either 4% or 8% towards their KiwiSaver scheme. The Act provides that if the employee elects, employer contributions count towards this (otherwise, the employer contribution is made on top of the 4% or 8%). This change was made during the select committee process of the KiwiSaver Bill because of a concern that low income earners would not be able to afford to contribute 4% of their salary or wages.

78. In view of the increased funding by the government for KiwiSaver, the proposal provided by the office of the Minister of Finance was for the ability for employer contributions to count towards the minimum contribution rate to be removed when compulsory employer contributions are introduced. This means that the minimum contribution rate for members joining from 1 April 2008 would be as follows:

Year	Employee contribution rate	Employer contribution rate	Total contribution rate
2008/09	4%	1%	5%
2009/10	4%	2%	6%
2010/11	4%	3%	7%
2011/12	4%	4%	8%

79. Under the proposal, if an existing arrangement was in place the ability for employer contributions to count towards the contribution rate would be phased out. From 2011/12 all employees will be required to contribute at least 4%. This is likely to make it more difficult for low income earners to contribute to KiwiSaver.

80. You are asked to formally agree that the ability for employer contributions to count towards the minimum contribution rate will no longer apply from 1 April 2008, but where an existing arrangement is in place, the ability for employer contributions to count towards the contribution rate will be phased out.

Vesting

Compulsory employer contributions

81. The question arises as to whether the compulsory employer contributions would be required to vest immediately in the employee, or whether employers could impose a vesting requirement. If vesting requirements were permitted on compulsory employer contributions (ie if they did not vest immediately), employers could effectively avoid or reduce the employer contributions payable to an employee by having a vesting scale and seeking to have the employer contribution refunded when the employee left employment. Given that the rationale of compulsory employer contributions is to increase employees' savings balances, officials consider that all contributions up to the level of the compulsory rate should be required to vest immediately with the employee. Employers would be able to impose vesting requirements on contributions in excess of the compulsory rate.

82. It should be noted that imposing a universal requirement for compulsory employer contributions to be fully vested may create the need for some trust deed amendments. This may be addressed by legislatively enabling employers who are already contributing at a rate at least equal to the compulsory amount to have their contributions fully vested. This would have the effect of allowing employers to retain the current contribution levels and have those contributions count towards the compulsory employer contribution rate.

Employer tax credit

83. The employer tax credit could be given either when the employer contribution is made, or when it vests in the employee. If the compulsory employer contributions are required to vest immediately in the employee, then both are the same point in time. That is, the employer tax credit would be given at the time the employer contribution is made.

84. There are some cases where the employer tax credit would apply in relation to voluntary contributions – ie on contributions where the employer could impose vesting conditions. However, there are likely to be very few such instances – it will only occur in situations where the compulsory employer contribution is less than $20 per week (ie where the employee earns less than $26,000 per year). There is a risk that if employer tax credits are given in respect of employer contributions before they had fully vested the employer may get a credit in respect of a contribution which the employee never fully owns. Giving the credit when they fully vest in the employee, however, would be administratively complex and would potentially impose high compliance costs on employers.

85. For simplicity, and in view of the limited cases this would apply, officials recommend that the employer tax credit be given when employer contributions are paid.

Payment of employer tax credit

86. The employer tax credit could be claimed annually or monthly by employers. As annual claims will create compliance costs and exacerbate cash flow issues for employers, officials consider that the credit should be claimed on a monthly basis.

87. It is proposed that Inland Revenue leverage off existing systems (such as PAYE) to minimise compliance costs and cash-flow implications. Officials consider the claim process should be linked to the employer monthly schedule either directly through the schedule or as a separate data capture at the same time that the schedule is filed. This approach is favoured for simplicity reasons also, as the same approach could be used to administer the claim regardless of whether the contributions are paid via Inland Revenue or directly to a provider.

Associated persons

88. The proposed member and employer tax credits increase incentives for people to establish KiwiSaver schemes to access tax credits. For example, through the establishment of a single person (or self-managed) KiwiSaver scheme, member contributions and tax credits could be loaned back to the member.

89. To prevent this from occurring it is recommended that investment restrictions be imposed. It is proposed that trustees of KiwiSaver schemes with fewer than 20 members be required to comply with certain investment restrictions including:

- precluding lending money or providing goods or services from the fund to an associated person (a person associated with the trustee or the member) for an amount less than market value; and
- precluding the acquisition of goods and services from a person associated with the superannuation fund for an amount greater than market value.

90. If Inland Revenue becomes aware of a breech of an investment restriction the Government Actuary will be informed. The Government Actuary then has the discretion to direct the trustee to act and has the power to deregister the scheme (in which case funds will be transferred to another KiwiSaver scheme).

Tax deductibility of employer contributions

91. It is recommended that the employer be able to claim a tax deduction only in respect of those employer contributions where there is not a corresponding credit – the tax credit already provides a favourable tax treatment of those contributions. Otherwise, the effective value of the credit would be 133 percent of its face value. This would significantly increase the fiscal cost. It is further recommended that the employer tax credit be treated as excluded income.[12]

Tax treatment of member tax credit

92. Arguably the member tax credit could be treated as assessable income (it has some of the characteristics of income, such as regularity). For clarity, it is recommended that the tax credit be treated as excluded income.

Interest

Member tax credit

93. The member tax credit will be claimed retrospectively by providers for their members on an annual basis, based on the member contribution information they hold. The question arises as to whether interest should apply to the member tax credit.

94. Interest is a fee charged by a lender to a borrower for the use of borrowed money, to compensate for the opportunity cost of any other use the money could be put (including lending to others, investing elsewhere, holding cash and simply spending the funds). Because the member tax credit is an amount paid as an incentive to save – not a repayment of overpaid tax (and therefore not money borrowed) – officials do not consider that interest should be payable. While the credit will be paid retrospectively to members' accounts it does not present a real opportunity cost to the member in terms of the use of their own money.

[12] Treating the tax credit as excluded, as opposed to exempt, income would enable expenses associated with claiming the credit to be deducted.

95. Further, the calculation of interest on tax credits would add considerable complexity to the credit claim and payment mechanism. To avoid confusion, KiwiSaver communication would make it clear that the member tax credit is paid on an annual basis retrospectively.

Employer tax credit

96. Provided that the employer tax credit is claimed monthly, officials do not consider the payment of interest is applicable.

Calculating the member tax credit

97. Given that the member tax credit is to be paid by the scheme provider making an annual claim based on the member contribution it holds, it is recommended that the credit be the lesser of the member's contribution or $1,040 per year, which equates to $20 per week. This would enable people with irregular income (such as the self-employed) to make contributions directly to providers on a less frequent basis than weekly and still receive the maximum value of the credit. Having a requirement to calculate the credit on a weekly basis would be administratively complex.

98. While a salary or wage earner could contribute directly to a provider in order to obtain the member tax credit (for example, take a contributions holiday and contribute $1,040 per year in order to receive a matching government contribution), the incentive will be to have deductions of contributions made from salary or wages in order to access compulsory employer contributions.

Calculating the compulsory employer contribution

99. It is recommended that the compulsory employer contribution be calculated on a payment basis. That is, the compulsory contribution would be 4% of each payment of salary or wages the employee receives (regardless of whether the salary or wages is paid weekly, fortnightly or monthly etc). The employer could not just make a one-off payment at the end of the year to meet all of its compulsory contributions for that year (because of the opportunity cost to the employee).

Calculating the employer tax credit

100. To further encourage employer contributions, officials recommend that the employer tax credit be able to be claimed in respect of both voluntary and compulsory contributions. It is only likely to be claimed in respect of voluntary contributions for those employees with low incomes. Once the compulsory contribution is fully phased in, an employee would have to be earning less than $26,000 per year for an employer to claim a tax credit in respect of a voluntary contribution.

Multiple employers

101. In some instances an employee will have multiple employers. Provided that the employers are not associated (and are therefore claiming tax credits for separate employer contributions in respect of the same member), officials consider that for equity and simplicity

reasons each should be entitled to receive the tax credit – to the extent to which they each individually contribute – to the maximum of $20 a week.

102. There is potential for double claims where there is more than one employer and the employers are not at arms length. For example, branch divisions of the same company or subsidiaries of the same company. In such cases, only one employer tax credit should be payable. This should be clearly communicated to employers. Officials consider that the penalty provisions in the Tax Administration Act should be applied where credits are claimed more than once in respect of the same employee.

Employers discriminating on the grounds of being a KiwiSaver member

103. The introduction of compulsory employer contributions may increase the likelihood of an employer refusing to employ somebody, or may offer an applicant less favourable terms of employment, because they are a KiwiSaver member. Officials will report to Ministers if there are concerns that this is occurring.

Ability to claw back tax credits

104. It is recommended that Inland Revenue have the ability to claw back tax credits if in any instance a person is later found to be ineligible to receive it. Officials will need to work through which provisions of the Tax Administration Act need to apply so that Inland Revenue can utilise its existing collection processes to claw back credits.

105. The ability to claw back tax credits will effectively require providers to cancel units in a person's KiwiSaver account. Officials will need to consult with the Ministry of Economic Development on whether this raises any issues under superannuation and securities law.

Application of member tax credit and compulsory employer contributions to investment products

106. It is recommended that the member tax credit and compulsory employer contributions be applied on a pro rata basis across the investment products that the person has chosen at the time the credit is received by the provider. It is also recommended that the member tax credit be applied to an account fully vested in the employee (to ensure that the full value of the credit is owned by the employee).

Time limit for claiming member tax credits

107. It is recommended that no time limit be imposed on claiming member tax credits. For example, if the provider was unable to claim a credit for a member because it did not have all of the information required by Inland Revenue (such as not having the person's IRD number), and subsequently obtained the necessary information, the member's entitlement to the credit would remain.

108. It is also recommended that if the member tax credit is not used in full in any one year, the remainder cannot be used the following year. If this were to be allowed, the likely result

would be that members would wait until just before the age of entitlement to withdraw their funds, deposit a large sum of money to obtain the member tax credit, and then draw down the whole amount. This is not conducive to encouraging a regular savings behaviour.

GST treatment of member tax credit and employer tax credit

109. Grants and subsidies made by the government can be subject to GST in certain circumstances. To ensure there is no uncertainty over the treatment of the tax credits, it is recommended that the GST (Grants and Subsidies) Order be amended to ensure that the member tax credit and the employer tax credit are not subject to GST.

Person must be living, or normally living, in New Zealand to join KiwiSaver

110. It is also recommended that a change be made to ensure that a person must be living, or normally living, in New Zealand to join KiwiSaver (with an exception applying in the case of government employees living overseas). This would ensure that Australian and New Zealand citizens who are just in the country for a holiday would not be able to join KiwiSaver (currently they could join).

Summary of recommendations for other detailed design issues

111. The table below summarises officials' recommendations in relation to the other detailed design issues:

OTHER DETAILED DESIGN ISSUES	KiwiSaver	Proposal for KiwiSaver enhanced package
Employer contributions counting towards the minimum contribution rate	Yes.	No. Where an existing arrangement in place ability for employer contributions to count towards the contribution rate or phased out.
Vesting	Employer contributions that count towards contribution rate must vest immediately, otherwise vesting scale can be imposed.	Compulsory contributions vest immediately.
Payment of employer tax credit	n/a	Monthly.
Employer contributions via Inland Revenue	Via Inland Revenue or directly to KiwiSaver scheme provider. Contributions to non-KiwiSaver schemes cannot be paid via Inland Revenue.	Must be via Inland Revenue. Contributions to non-KiwiSaver schemes cannot be paid via Inland Revenue.
Associated persons	Allows loaning to members or investing in a member's business, but requires appointment of an independent trustee.	Limit the investments allowed if less than 20 members.
Deduction of employer contributions	Can claim a tax deduction	Can only claim a tax deduction for the portion of contributions where there is no corresponding credit.
Tax treatment of tax credits	n/a	Treated as excluded income.
Interest	n/a	Interest not payable on tax credits.
Calculating member tax credit	n/a	Annual basis ($1,040 per year).
Calculating compulsory employer contribution	n/a	Payment basis.
Calculating employer tax credit	n/a	Employer tax credit applies in respect of voluntary and compulsory contributions.
Multiple employers	n/a	Employer tax credit applies to each employer, except where associated.
Employers discriminating on the grounds of being a KiwiSaver member		Officials will report to Ministers if there are concerns this is occurring.
Ability to claw back credits	n/a	Tax credits can be clawed back if a person is found to be ineligible to receive them.
Application of member tax credit and compulsory employer contributions to investment products		Member tax credit and compulsory employer contributions be applied on a pro rata basis across investment products that the person has chosen at the time the credit is received and are applied to an account fully vested in the employee.
Time limit for claiming member tax credit	n/a	No time limit be imposed on claiming member tax credits. If the member tax credit is not used in full in one year the remained cannot be used the following year.
GST treatment of member tax credit and employer tax credit	n/a	Ensure that both tax credits are not subject to GST.
Must live in NZ to join KiwiSaver	Must be personally present, or normally personally present, in NZ to join.	Person must be living or normally living in NZ to join KiwiSaver.

(c) Implementation

112. *[information deleted as disclosure would prejudice the maintenance of the law*

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Member tax credit

113. The proposal for the member tax credit is based on the scheme provider submitting an annual return showing each member's details and the amount of contributions eligible for the tax credit. Inland Revenue would then pay the tax credit to the provider to be deposited to the member's KiwiSaver account. Provided this feature of the proposal is retained, Inland Revenue can deliver the change from 1 July 2007.

Employer tax credit

114. To minimise cash flow impacts and compliance costs employers will claim the tax credit leveraging off the employer monthly schedule process. Provided no additional requirements arise, Inland Revenue can deliver the change by 1 April 2008.

Compulsory employer contributions

115. Employers who contribute to KiwiSaver schemes will be required to pay employer contributions via Inland Revenue. This does not cause any implementation issues.

[information deleted as disclosure would prejudice the maintenance of the law

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Consultation

127. The Ministry of Economic Development has been consulted on the proposals in this report. The Ministry of Justice was consulted on the Bill of Rights issue.

Appendix – current KiwiSaver design

This appendix outlines the current KiwiSaver design and explains some of the policy rationale behind the detailed design parameters.

Who is eligible to join KiwiSaver?

Anybody who is entitled to be in New Zealand indefinitely in terms of the Immigration Act 1987 is eligible to be a KiwiSaver member (whether employed or not), up until the age of eligibility for New Zealand Superannuation (NZS), currently 65 years. The effect is that New Zealand citizens, permanent residents and Australian residents are eligible to join. A person must be personally present, or normally personally present, in New Zealand to join, unless they are employed by the government. This means that someone posted overseas and working for the army, for example, would still be able to join KiwiSaver. Only natural persons are able to join.

Which employers does KiwiSaver apply to?

The KiwiSaver Act applies to employers who are tax resident or carry on business from a fixed establishment in New Zealand (such as operating through a branch structure).

Mortgage diversion

The KiwiSaver Act permits the Governor-General to make regulations, on the recommendation of the Minister of Finance, providing for a mortgage diversion facility that allows contributions to be withdrawn from KiwiSaver schemes and applied towards payment of a mortgage. Cabinet has previously agreed that regulations be made to provide for a mortgage diversion facility (EDC Min (07) 5/1 refers). One of the key features of mortgage diversion is that employer contributions are unable to be diverted. This design feature was incorporated so that employers had certainty that any contributions they made would specifically go towards retirement savings.

First home ownership withdrawal

The KiwiSaver Act provides for a member to withdraw their funds for the purchase of a first home (the $1,000 kick-start payment cannot be withdrawn). The purchase must be for the person’s principal place of residence and the withdrawal cannot occur until three years after joining.

Employer contributions are able to be withdrawn under the first home ownership withdrawal facility provided that they have vested in the employee. One of the policy rationales for the first home withdrawal facility was to allow those who are entering the housing market for the first time a ‘hand up’. Given that it has become increasingly difficult for first home buyers to enter the housing market, allowing employer contributions to be withdrawn under the first home ownership withdrawal facility would potentially allow for a bigger deposit, and therefore the ability to purchase a house at an earlier point in time (or to decrease the size of the mortgage needed).

Significant financial hardship withdrawal

The KiwiSaver Act provides for a member to withdraw their funds if they are suffering, or likely to suffer, significant financial hardship (excluding the $1,000 kick-start payment). Any reasonable alternative sources of funding must have been explored and exhausted, and the amount withdrawn may be limited to a specified amount that is required to alleviate the particular hardship.

Serious illness

Members are currently able to withdraw their funds (excluding the $1,000 kick-start payment) if they are suffering serious illness. Cabinet has previously agreed that the definition of "serious illness" be modified, so that the withdrawal facility would be available only if a member is totally and permanently disabled or where death is imminent (CBC Min (07) 5/3 refers). Cabinet also agreed that in such cases the member be able to withdraw the $1,000 kick-start payment (effectively the person is treated as retired if they meet the test).

Permanent emigration

The KiwiSaver Act provides that a member can withdraw all of the funds in their KiwiSaver account (including the $1,000 kick-start payment) one year or more after their permanent emigration from New Zealand. A member must sign a statement that they have permanently emigrated and provide proof of their departure from New Zealand and that they have resided at an overseas address at some time during the year following departure. Furthermore, a member may at any time after permanently emigrating transfer all of the funds in their KiwiSaver scheme to a foreign superannuation scheme authorised for that purpose by regulations. No regulations have been made under this provision.

The permanent emigration withdrawal facility was introduced to address a concern that emigration would lead to a number of accounts with small balances, contributing to higher administrative costs and creating a drag on the returns for scheme members. Officials understand that the issue of small balances is a problem in Australia.

Death

The KiwiSaver Act provides for withdrawal of all funds in a member's account (including the $1,000 kick-start payment) upon death. The funds are paid to the member's estate.

Age of eligibility for withdrawal

The KiwiSaver Act provides that, subject to other permitted withdrawals, a member's funds in the scheme are locked in until the later of the date on which the person reaches NZS qualification age (currently 65 years) or five years membership in a KiwiSaver scheme. A member is entitled, but not required, to withdraw their funds at that date.

Vesting

Currently employers can impose vesting requirements on employer contributions to an employee's KiwiSaver scheme, provided the contribution does not count towards the employee's contribution rate. Similarly, employers that contribute to complying funds can impose vesting requirements on their contributions, unless those contributions count towards the minimum 4% contribution rate.

Associated persons

Currently the KiwiSaver Act does not prevent a KiwiSaver scheme from loaning money to members or investing in the business of the member. It does, however, require the appointment of an independent trustee and the provider entering into a scheme provider agreement with Inland Revenue. In addition, the KiwiSaver Act prohibits the assignment or charging of a members' interest (ie members cannot borrow against their KiwiSaver funds).