

Treasury Report: KiwiSaver - Draft Bill and Other Matters

Date:	16 December 2005	Treasury Priority:	MEDIUM
Security Level:	IN-CONFIDENCE	Report No:	T2005/2366

Action Sought

	Action Sought	Deadline
Minister of Finance	Note a draft KiwiSaver Bill is attached Agree to all recommendations	23 December 2005
Minister of Commerce	Note a draft KiwiSaver Bill is attached	None
Minister of Revenue	Note a draft KiwiSaver Bill is attached Agree to recommendations e to k	23 December 2005
Associate Minister of Finance (Hon Phil Goff)	Note	None
Associate Minister of Finance (Hon Trevor Mallard)	Note	None
Associate Minister of Finance (Hon Clayton Cosgrove)	Note	None

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
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Enclosure: Yes

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Treasury Report: KiwiSaver - Draft Bill and Other Matters

Executive Summary

The draft KiwiSaver Bill is enclosed for your information and any comment. The draft Bill is preliminary and based on your decisions to date, excluding your decision made yesterday regarding investment statements and small balances, and including the recommendations in this report.

While considerable progress has been made on the Bill, a number of tasks remain to be completed and the time line going forward remains tight. Officials will continue to progress this work in order to ensure a Bill is ready for introduction in late February. Some risks remain but officials consider these risks can be managed.

Given the tight timeframes, decisions from Ministers are being sought on several detail policy design issues, including the qualifying collective investment vehicle (QCIV) status of KiwiSaver schemes.

You are required to consult with the Ministers of Education and Housing in making detailed design decisions. We assume that for the purposes of this consultation that you are the relevant Minister of Education. If this is not the case, you may want to consult with your colleague the Minister of Education also.

Recommended Action

We recommend that you:

- a **note** that a preliminary draft KiwiSaver Bill is enclosed for your information and any comment. Preliminary comments by Christmas would be appreciated, but are not necessary;
- b **agree** that officials can consult with the Association of Superannuation Funds of New Zealand on the clauses on the conversion of existing registered superannuation schemes and the employer exemption from the automatic enrolment mechanism to ensure that the provisions work as intended;

Agree/disagree.

Minister of Finance

- c **note** that employers, providers and industry group raised some concern about aspect of the detailed design during recent consultations;
- d **refer** this report to the Minister of Housing;

Referred: Yes/No

Minister of Finance

- e **agree** that KiwiSaver default providers be required to become qualifying collective investment vehicles (QCIV) to ensure low income earners are not over taxed but that active choice providers can decide their QCIV status;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Revenue

- f **agree** that private domestic workers not be subject to the automatic enrolment mechanism but be able to opt-in to KiwiSaver;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Revenue

- g **agree** that the registration process with the Government Actuary include a requirement that providers meet the Inland Revenue central administration requirements to ensure information and funds can be efficiently exchanged;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Revenue

- h **agree** that providers and Inland Revenue should be required to exchange relevant information in electronic format prescribed by Inland Revenue;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Revenue

- i **agree** that once an employee is eligible to take a contribution holiday, any contribution holiday issued by Inland Revenue should be for a minimum duration of three months for administrative purposes;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Revenue

- j **agree** that where an employee requests that a contribution holiday apply to or cease for a specific job, the holiday will apply or cease for at least three months, unless an employer and employee agree otherwise, to address employer concerns that employees may stop or restart their contributions more frequently;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Revenue

k **agree** that the normal tax disputes process apply to the withholding of KiwiSaver contributions by employers.

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Revenue

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Treasury Report: KiwiSaver - draft Bill and other matters

Purpose of Report

1. This report provides you with a copy of the draft KiwiSaver Bill and updates you both on the legislative time line and recent consultation feedback. In addition, the paper seeks your agreement to several detailed policy design issues.

Analysis

Draft Bill

2. A draft KiwiSaver Bill has been provided for your information and comment. This draft Bill is based on decisions taken to date, excluding any decisions taken yesterday on the way investment statements are distributed in response to the Ministry of Economic Development's report: *KiwiSaver: Investment Statements and Small Balances*, and on the basis of the recommendations taken in this report.
3. The draft is preliminary only and officials will continue to work on the Bill. Officials have identified some further issues that should be covered in the Bill as well as a small number of changes to the Bill that will be needed. This includes issues such as information sharing between the Government Actuary and Inland Revenue, privacy of tax confidential information, the application of the Public Finance Act to Inland Revenue's holding account, drafting around the fee subsidy, the application of the Financial Transactions Reporting Act and a range of other issues. Drafting instructions have not been provided on these matters but these instructions will be provided to the Parliamentary Counsel Office (PCO) by mid January.
4. Officials still need to undertake an overall check of the Bill to ensure that the separate components of drafting hang together and that material is at the appropriate level of detail. Officials have made a number of decisions about what material is in primary and secondary legislation to ensure the regime is sufficiently flexible and can be altered over time, if needed.
5. A brief outline of the Bill is included in the appendix. The Bill includes a draft explanatory note which outlines the general policy underlying KiwiSaver and some analysis of key clauses in the Bill. A regulatory impact statement for the Bill has not been drafted yet but will be available in mid January.
6. Parts of the Bill Ministers may be particularly interested in are:
 - the purpose statement (clause 3 on page 6 of the Bill);
 - the ability to change the 4% and 8% deduction rates by Order in Council (clause 56 on page 29 of the Bill);
 - the regulations power, especially the ability to set the detail of the fee subsidy (clause 176 on page 77 of the Bill); and
 - the exclusion of the setting of the government's \$1000 contribution from the Bill.

Legislative Time Line

7. Officials have previously advised that to meet a 1 April 2007 implementation date that legislation would need to be introduced in late February 2006 and Royal Assent in October 2006 [T2005/2009 and PAD2005/192 refers].
8. While considerable progress has been made on the Bill, the tasks left to complete are:
 - additional drafting instructions to PCO;
 - preparation of the regulatory impact statement;
 - iterations of the Bill from review;
 - consultation with other parties and government agencies;
 - seeking additional policy authority; and
 - approval to introduce the Bill.
9. Officials believe we can complete this work over the next couple of months in time to deliver a Bill for introduction in late February. However, the timeframe is very tight, and there is the potential for introduction to be delayed for a week or two if any problems arise during further consultation on the Bill with other government agencies and political parties. Officials believe that we can manage most of these risks and we are working hard to meet the February deadline. The tight February timeframe also has the potential to affect the quality of the Bill, as it leaves limited time for quality control and wider consultation on a draft Bill.
10. Officials consider that it would be desirable to consult with the Association of Superannuation Funds of New Zealand (ASFONZ) on the clauses on the conversion of existing registered superannuation schemes and the employer exemption from the automatic enrolment mechanism to ensure that the provisions work as intended.

Consultation Feedback

11. Officials have undertaken further consultation with potential KiwiSaver providers, employers, payroll software providers and industry groups on the detailed design of KiwiSaver.
12. MED provided details of the feedback received on investment statements and small balances (MED report: *KiwiSaver: Investment Statements and Small Balances*).
13. Other common messages from providers were:
 - the timeframe for implementation of KiwiSaver is ambitious given system implementation for providers could take at least 9 months;
 - the fee subsidy being set at a flat amount per member (i.e. unrelated to the level of contributions or balance) was generally preferred;
 - the qualifying collective investment vehicle (QCIV) status of KiwiSaver needs to be known as it will be important for the implementation process, costs of change and unit pricing structure;
 - providers had differing views on the likely demand for existing registered superannuation schemes (defined contribution schemes) for the conversion mechanisms;

- default providers should be required to accept all new members, according to some providers;
 - providers of work based superannuation schemes currently rely on the employer to verify the identify of employees to meet the know your customer requirements under the Financial Transactions Reporting Act. This verification is designed to minimise the risk of funds being linked to money laundering. The lack of application forms for members of default schemes means that a verification process may not be possible for KiwiSaver default providers;
 - consistent decisions on financial hardship across all KiwiSaver schemes will be important; and
 - there was support for using the IRD number as the member's unique identifier.
14. Other key messages from employers, payroll software providers and industry groups were:
- 1 April is already a busy time of year for businesses;
 - KiwiSaver should be easily integrated into existing payroll software but integration may be less straightforward if operating a manual payroll system;
 - mixed views on having just two contribution rates – some preferred the simplicity while others felt contributions above a minimum any rate should be permitted;
 - employers would be concerned if they have to enrol casual staff in KiwiSaver unless the employee is already a KiwiSaver member;
 - the ability to obtain a contribution holiday would not encourage saving;
 - there is a potential clash between the Inland Revenue as the scheme administrator and its regulator;
 - employers are concerned at being subject to penalties for minor transgressions, so would prefer more instructions from the Inland Revenue, such as when contributions should commence for each employee, to minimise this risk;
 - an educational campaign will be essential to the success of the KiwiSaver message; and
 - free financial advice should be available for employees.
15. Some of the concerns of providers, employers and industry groups have been addressed by your decisions yesterday.

Detailed Design Issues

16. Given the tight timeframes, officials have included a number of detailed design issues in the draft Bill which have yet to be agreed by Ministers. Officials are seeking your agreement to these following matters.

QCIV Status

17. It is important that if employees are encouraged to save through work-based savings, that the earnings from such investments are taxed consistently and fairly.
18. The taxation of investment income proposals are designed to achieve this. It is anticipated that from 1 April 2007, a pooled fund that qualifies as a QCIV would be able to elect a new set of tax rules.
19. Under the new tax rules for QCIVs, assessable income would generally exclude realised domestic share gains. Assessable income will also be "flowed through" to investors, with the QCIV deducting tax at investors' elected tax rates.
20. Initially, the QCIV tax treatment will be optional due to the costs associated with setting up and operating as a QCIV. The loss of the 6% tax rate advantage to high income investors, under "flow through" tax treatment, will also mean that some fund providers may not elect to be QCIVs.
21. A question arises in relation to KiwiSaver schemes as to who should make the QCIV election decision.
22. In general, officials consider that this decision should be left up to individual trustees. They will make a decision in the best interests of their investors. For active choice KiwiSaver schemes, if that decision is not in the interests of a particular individual investor, they would be able to elect to transfer into another KiwiSaver scheme better suited to their needs.
23. For default schemes, however, officials consider that the Government should make the QCIV election decision. Taxpayers who do not make an active choice decision will be automatically enrolled into default KiwiSaver schemes. For default schemes, unless mandated, trustees focussing on the needs of the majority investor may not meet the needs of those on low incomes. While individual default investors will still be able to transfer into another KiwiSaver scheme which better suits their needs, low income investors will have less incentive (based on absolute level of investment) to do so and may also be less financially sophisticated.
24. Officials therefore recommend that it should be mandatory for all default KiwiSaver providers to be taxed as QCIVs as this will best meet the needs of those on low incomes. Having low income savers taxed at their correct marginal tax rate was a stated aim of the QCIV tax changes in the 2005 Budget.
25. The QCIV tax changes are on a different legislative track (at this stage a May 2006 tax bill is envisaged) to KiwiSaver. This creates risks that the tax changes may not align with KiwiSaver in the 2007 year.

Private Domestic Workers

26. Generally, an employer must deduct PAYE from a source deduction payment (that is, from any payment that is salary or wages, an extra emolument, or a withholding payment). An exception for this rule is a payment made to a private domestic worker. A private domestic worker is a person who works for a householder in a private capacity and works no more than thirty hours a week on average for each employer. This includes home-helpers, gardeners, nannies and attendant caregivers. These persons are required to pay their own PAYE.

27. Officials consider that such persons should be able to join and contribute to KiwiSaver either by going direct to a provider or via the Inland Revenue. KiwiSaver contributions would be made along with PAYE payments. However, officials consider that the automatic enrolment mechanism should not apply to these employees.

Relationship between Providers and Inland Revenue

28. It will be important to ensure that active choice providers approved by the Government Actuary are able to deal with the Inland Revenue's central administration system for receiving funds and exchanging information. Therefore, officials recommend that the registration process with the Government Actuary include a requirement that providers meet these Inland Revenue requirements notwithstanding that this may exclude some providers from being able to register.
29. The administration costs of the Inland Revenue receiving and sending information to providers in non-electronic forms would be high. Therefore, officials consider that providers and the Inland Revenue should be required to exchange relevant information in electronic format and that the electronic format be prescribed by the Inland Revenue.

Contribution Holidays

30. You have agreed that a KiwiSaver member may apply for a contribution holiday for a period of five years or less at a time. Contributions will commence following the expiry of a contribution holiday, unless the employee makes a new application. For administrative purposes, officials consider that there should be also be a minimum contribution holiday duration and consider that a three month time period would be a reasonable.
31. During consultation employers expressed concern that they could be exposed to additional compliance costs due to employee requests to start and stop contributions frequently. While a holiday will be granted for a set period and currently may be revoked at any time by notifying the employer and the Inland Revenue, revoking a valid contribution holiday would not prevent an employee from re-presenting the contribution holiday letter to the employer and requesting to cease deductions again.
32. To mitigate this risk officials consider that a limitation should be placed on employee requests to an employer for a contribution holiday. Officials consider the most appropriate way to do this is to provide that where an employee requests that a contribution holiday apply or cease for a specific job, the holiday will apply or cease for a set minimum period, say three months, unless an employer and employee agree otherwise.

Inland Revenue Disputes Process

33. Officials consider that the tax disputes process should apply to KiwiSaver contributions deducted by employers. This will avoid the cost of establishing a separate disputes process to deal with KiwiSaver and will also mean PAYE and KiwiSaver disputes can be dealt with under the same process.
34. The disputes procedures are set out in Part IVA of the Tax Administration Act 1994 and apply to all tax returns, notices of assessment and disputable decisions which become subject to challenge proceedings under Part VIIIA of the Tax Administration Act 1994. In respect of KiwiSaver they should apply to deductions to be made from salary or wages.

Further Report Backs

35. Further decisions are likely to be required in the following areas, which have not yet been included in the draft Bill:
- on the fee subsidy, including which agency administers, the payment and administration of the subsidy and any monitoring requirements;
 - independent trustees being required for KiwiSaver schemes;
 - Public Finance Act implications of unidentified money held by the Inland Revenue and interest paid;
 - privacy implications and the use of information obtained as part of the administration of the tax system being used for KiwiSaver purposes;
 - eligibility for financial hardship withdrawal while funds are held by the Inland Revenue;
 - tax implications of registered superannuation schemes that convert to KiwiSaver scheme;
 - the application of the Financial Transactions Reporting Act provisions to prevent money laundering to KiwiSaver;
 - further clarification of KiwiSaver penalties, if necessary;
 - whether the issues with small balances can be further alleviated by holding them in one central holding place; and
 - the relationship between the Inland Revenue and the Government Actuary.
36. Officials propose to report to you on these matters in early 2006. A further Cabinet policy paper will be required to seek Cabinet agreement to changes that have been made to previous Cabinet papers or which are fundamental to the scheme. Any Cabinet paper could be sent to the first Cabinet meetings in early 2006.

Appendix

The following is a high-level guide to the draft KiwiSaver Bill:

Part 1 contains the preliminary provisions, including setting out the purpose of the Bill;

Part 2 relates to membership of KiwiSaver, including the operation of automatic enrolment, allocation of members to default schemes, and eligibility rules for opting in to KiwiSaver;

Part 3 covers contributions to KiwiSaver, including provisions for employers to deduct contributions from salary or wages, contribution rates, funds held by Inland Revenue during the initial 3 month period and interest payable during this period, and the operation of contribution holidays;

Part 4 relates to the regulatory environment for KiwiSaver schemes, including application of the Superannuation Schemes Act 1989, registration of KiwiSaver schemes, and conversion of existing registered superannuation schemes;

Part 5 contains general provisions, for example, no Crown guarantee of KiwiSaver schemes, application of the Securities Act 1978, exclusion of liability as promoters or financial advisers, information sharing, and unclaimed money;

Schedule 1 contains the KiwiSaver rules, such as the lock-in of funds, withdrawals and transfers of funds; and

Schedule 2 outlines what matters must be specified in applications for registration.