Inland Revenue
Te Tari Taake

POLICY ADVICE DIVISION

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Extending the KiwiSaver SSCWT exemption to other registered superannuation schemes

Date:	27 November 2006	**Priority:**	**High**
Security Level:	Sensitive	**Report No:**	T2006/2235 PAD2006/257

Action sought

	Action Sought	**Deadline**
Minister of Finance	Agree to recommendations, sign and refer attached Cabinet paper	10am 30 November 2006
Associate Minister of Finance (Hon Phil Goff)	Note contents	None
Associate Minister of Finance (Hon Trevor Mallard)	Note contents	None
Associate Minister of Finance (Hon Clayton Cosgrove)	Note contents	None
Minister of Revenue	Agree to recommendations, sign and refer attached Cabinet paper	10am 30 November 2006

Contact for telephone discussion (if required)

Name	**Position**		**Telephone**

27 November 2006

Minister of Finance
Minister of Revenue
cc: Associate Minister of Finance (Hon Phil Goff)
Associate Minister of Finance (Hon Trevor Mallard)
Associate Minister of Finance (Hon Clayton Cosgrove)

Extending the KiwiSaver SSCWT exemption to other registered superannuation schemes

Executive summary

This report is in two parts. Part one discusses how the exemption from specified superannuation contribution withholding tax (SSCWT) afforded to employer contributions to KiwiSaver schemes could be extended to include employer contributions to other registered superannuation schemes (RSS). Part two discusses how a principle-based approach for setting a boundary for a tax exemption could be applied. Setting a boundary is important given that, if the exemption were to be extended, it is inevitable that there would be calls for it to be extended further.

Part one – proposed option to extend the KiwiSaver SSCWT exemption

The Association of Superannuation Funds of New Zealand (ASFONZ) considers that if the exemption is not extended existing schemes may wind-up, resulting in the distribution of savings from those schemes. To mitigate this risk, an option to extend the SSCWT exemption has been proposed by ASFONZ. Under the option, employer contributions would be eligible for the exemption if they are subject to the same lock-in rules as KiwiSaver. This would be achieved by allowing a separate account (subject to KiwiSaver lock-in) to be administered within the existing trust deed. As is the case with contributions to KiwiSaver, the exemption would be capped at the lesser of the employee's contribution or 4% of the employee's salary or wages.

Only those contributions that count towards the amount exempted from SSCWT would be required to be subject to the KiwiSaver lock-in rules, while any remaining contributions could be subject to the scheme's normal withdrawal rules (eg with a 10% employee and a 10% employer contribution, 8% could be subject to the KiwiSaver lock-in rules and the remaining 12% subject to the scheme's normal withdrawal rules). Funds already saved would be subject to the scheme's normal withdrawal rules.

The issues/risks associated with extending the exemption are summarised in the table below:

Issue/risk	**Likelihood of occurring/estimated impact**	
	Keeping status quo (exemption not extended)	**Exemption extended**
Winding up of existing RSS with distribution of savings from those schemes	Medium. The risk of wind-up is higher than if the exemption is extended. Wind-up may occur because the exemption has created a distortion in that KiwiSaver is a tax-preferred investment, leading to a switch to KiwiSaver rather than contributing to existing RSS. The introduction of KiwiSaver is likely to result in the wind-up of some existing RSS over the longer term regardless of whether the exemption is extended. Over time, existing RSS members may switch to KiwiSaver and people who are not currently a member of a scheme may join KiwiSaver as opposed to joining an existing RSS.	Low to medium. The risk of wind-up is lower than the status quo as savers would be incentivised to continue saving in existing vehicles. The introduction of KiwiSaver is likely to result in the wind-up of some existing RSS over the longer term regardless of whether the exemption is extended. Over time, existing RSS members may switch to KiwiSaver and people who are not currently a member of a scheme may join KiwiSaver as opposed to joining an existing RSS.
Switch in savings products rather than increase in new savings	High. Some members of existing RSS are likely to substitute their existing savings for savings through KiwiSaver.	High. Some members of existing RSS are likely to substitute their existing savings for savings into accounts with the same lock-in rules as KiwiSaver.
Compliance costs	High. There is the potential for two systems to be administered by employers – KiwiSaver and the existing RSS.	Low. Only one system has to be administered (although employers will still need to provide access to KiwiSaver for those who opt in).
Fiscal costs	Nil. The costings for the KiwiSaver SSCWT exemption assumed that there would be some members of existing RSS who would join KiwiSaver.	Fiscal cost of $17m in 2007/08, $18m in 2008/09, $19m in 2009/10 and $20m in 2010/11 and outyears in foregone revenue. These costs are sensitive to a number of key assumptions, such as take-up rates.
Administration costs	Nil.	The Government Actuary would seek funding of $0.150 million in 2006/07 and 2007/08 ($0.100 million would third party funded and $0.050 million would be Crown funded).
Boundary difficult to defend against calls for further extensions	Medium. Any exemption leads to calls for it to be extended but the further the exemption is extended the more difficult it will be to defend against further extensions.	High. There is a risk that there will be pressure for employee contributions and contributions from the self-employed to be tax free.

Extending the SSCWT exemption will have a fiscal cost and the costs are sensitive to a number of assumptions, particularly the take up rate (the number of members of existing schemes who avail themselves of the exemption) and the double counting rate (the number of members who would have joined KiwiSaver if the exemption was not extended). These assumptions are very uncertain and their sensitivity could mean there is a fiscal risk in 2007/08.

Inland Revenue considers that the exemption should not be extended (because of the associated boundary risks), while the Treasury and the Ministry of Economic Development consider that it should be extended (because of the risk of wind-up).

Part two – a principle-based approach to setting a boundary for the application of a tax exemption

If the SSCWT exemption is extended it is important that there is a firm boundary that communicates the circumstances under which a tax exemption should apply. Having a clear principle-based boundary will not only provide surety for public communications, comment and debate on the extension, but will also help to ensure that the integrity of the tax system is maintained.

Officials recommend the following decision-making principles be adopted:

- Principle 1: Neutrality (for example, ensuring a more level playing field between KiwiSaver and other superannuation products)
- Principle 2: Guarding against the risk of leakage of existing superannuation savings
- Principle 3: Encouraging employers to contribute to employees' savings
- Principle 4: Reducing opportunities for tax avoidance

There is a risk that the exemption from SSCWT could become a tax exemption that applies more broadly than just to employer contributions. Officials have identified a number of areas in which the SSCWT exemption is potentially at risk of 'creep'. Using the above principles, officials consider that the exemption:

- should apply only to employer contributions to schemes that meet the portfolio investment entity criteria of having at least 20 non-associated members;
- should apply only to employer contributions to schemes in existence when KiwiSaver is implemented at 1 July 2007 (there is no risk of leakage in respect of schemes not yet in existence);
- should apply only to employer contributions to defined contribution schemes; and
- should apply only to employer contributions to registered superannuation schemes.

An SSCWT exemption cannot be applied to contributions made by the self-employed or employees because they do not pay SSCWT. If a tax exemption were to apply to such contributions, further work would be required as there may be administrative costs associated with such a change that have not been explored. It is indefinite under the principles whether contributions from the self-employed should be eligible (principle 1 could suggest that it should, while principle 3 could suggest that it should not). Principle 3 suggests that a tax exemption should not apply to employee contributions.

Cabinet paper

If you would like to extend the exemption as outlined in this report, attached is a paper for you to sign and refer to the Cabinet Economic Development Committee which seeks approval for the SSCWT exemption to be extended to other registered superannuation schemes.

For the Cabinet Economic Development Committee to consider the paper at its meeting of 6 December 2006, the paper must be referred to the Cabinet Office by 10am, 30 November 2006.

Recommended action

It is recommended you:

(a) **Agree** that:

either (Inland Revenue preferred option)

i. the KiwiSaver SSCWT exemption not be extended to include employer contributions to other registered superannuation schemes.

Agreed / Not agreed Agreed / Not agreed

or (Treasury and Ministry of Economic Development preferred option)

ii. the KiwiSaver SSCWT exemption be extended to include employer contributions to other registered superannuation schemes.

Agreed / Not agreed Agreed / Not agreed

If recommendation (a)(ii) is agreed to:

(b) **Agree** that the following design features apply:

KiwiSaver design features

- the exemption for employer contributions apply up to a cap of the lesser of the employee's contribution to the scheme or 4% of the employee's salary or wages;
- as a minimum, the KiwiSaver lock-in rules relating to withdrawals apply and more lenient withdrawal provisions not be permitted. That is, lock-in until age 65 or five years of membership, whichever is the later, except for:
  - first home ownership;
  - significant financial hardship;
  - serious illness; or
  - permanent emigration;
- the minimum contribution rate to the locked-in account be 4% of the employee's gross base salary or wages; and
  - employer contributions can count towards the contribution rate;
  - if such contributions count, the contributions have to vest immediately; and
- members be unable to borrow against the amount locked-in.

Non-KiwiSaver design features

- contributions (both member and employer) that are subject to the KiwiSaver lock-in rules are required to be transferred to a KiwiSaver scheme or another approved scheme, if the member ceases to be eligible to be a member of that scheme or otherwise ceases membership.

Agreed / Not agreed Agreed / Not agreed

(c) **Agree** that only those future employee and employer contributions that count towards the amount exempted from SSCWT are required to be subject to the KiwiSaver lock-in rules.

Agreed / Not agreed Agreed / Not agreed

(d) **Agree** that the exemption apply only to employer contributions to schemes that meet the portfolio investment entity criteria of having at least 20 non-associated members.

Agreed / Not agreed Agreed / Not agreed

(e) **Agree** that the exemption apply only to employer contributions to schemes in existence when KiwiSaver is implemented (1 July 2007).

Agreed / Not agreed Agreed / Not agreed

(f) **Agree** that the exemption apply only to employer contributions to defined contribution schemes.

Agreed / Not agreed Agreed / Not agreed

(g) **Agree** that a tax exemption apply only to employer contributions to registered superannuation schemes.

Agreed / Not agreed Agreed / Not agreed

(h) **Agree** that for employer contributions to registered superannuation schemes to be eligible for the exemption, the Government Actuary must approve the scheme as having met the above criteria.

Agreed / Not agreed Agreed / Not agreed

(i) **Agree** that if there are calls for an exemption to apply more broadly than the circumstances described in recommendations (b) – (h) the following principles be communicated as the circumstances under which a tax exemption should apply:

- Principle 1: Neutrality (for example, ensuring a more level playing field between KiwiSaver and other superannuation products)
- Principle 2: Guarding against the risk of leakage of existing superannuation savings

- Principle 3: Encouraging employers to contribute to employees' savings
- Principle 4: Reducing opportunities for tax avoidance

Agreed / Not agreed Agreed / Not agreed

(j) **Note** that it is indefinite under the principles whether a tax exemption should apply to contributions made by the self-employed and that any application of a tax exemption to contributions made by the self-employed or employees would require further work.

Noted Noted

(k) **Note** that it is estimated that extending the SSCWT exemption as outlined in recommendations (b) – (h) would have the following fiscal costs, and that these costs are sensitive to a number of assumptions:

	$m – increase/(decrease)				
Vote Revenue Minister of Revenue	**2007/08**	**2008/09**	**2009/10**	**2010/11**	**2011/12& Outyears**
Tax Revenue	(17)	(18)	(19)	(20)	(20)
Total	(17)	(18)	(19)	(20)	(20)

Noted Noted

(l) **Note** that if the SSCWT exemption is extended as outlined above Inland Revenue would fund administration costs out of existing baselines and the Government Actuary would seek funding of $0.150 million in 2006/07 and 2007/08 ($0.100 million would third party funded and $0.050 million would be Crown funded).

Noted Noted

(m) **Agree** that amendments be made to give effect to the recommendations outlined above by way of a Supplementary Order Paper to the Taxation (Annual Rates, Savings, Investment, and Miscellaneous Provisions) Bill at the Committee of the Whole House stage of the Bill.

Agreed / Not agreed Agreed / Not agreed

(n) **Agree** that approval be sought from Cabinet for the Ministers of Finance and Revenue to be delegated authority to introduce such a Supplementary Order Paper.

Agreed / Not agreed Agreed / Not agreed

(o) **Agree** that a press statement be drafted to announce the extension of the SSCWT exemption, for release after Cabinet has considered the proposal.

Agreed / Not agreed Agreed / Not agreed

(p) **Note** that officials plan to release this report, and any associated Cabinet papers, on the Treasury website after any announcement to extend the SSCWT exemption is made.

Noted	Noted

(q) **Sign** and **refer** the attached paper to the Cabinet Office by 10am, 30 November 2006.

Signed and referred	Signed and referred

(r) **Refer** a copy of this report to your colleague, the Minister for Commerce.

Referred	Referred

Vicky Robertson
Director, Regulatory and Tax Policy Branch
for Secretary to the Treasury

Matt Benge
Assistant Deputy Commissioner,
Policy, Inland Revenue

Hon Dr Michael Cullen
Minister of Finance

Hon Peter Dunne
Minister of Revenue

Background

1. This report discusses the issue of how the exemption from specified superannuation contribution withholding tax (SSCWT) afforded to employer contributions to a KiwiSaver scheme could be extended to include employer contributions to other registered superannuation schemes (RSS). Representatives of the Association of Superannuation Funds of New Zealand (ASFONZ) and other superannuation schemes have raised concerns with the Minister of Finance that the existing exemption creates distortions because KiwiSaver is a tax-preferred investment. ASFONZ considers that this may lead to the winding up of existing schemes to which employers contribute and the subsequent distribution of savings from those schemes.

2. Officials met with representatives of ASFONZ to discuss these concerns and their proposal to extend the SSCWT exemption. Under the proposed option, both employer and employee contributions would be subject to the same lock-in rules that apply to KiwiSaver schemes. This approach was briefly canvassed during the Minister of Finance's meeting with ASFONZ on 14 September 2006.

3. The KiwiSaver SSCWT exemption was introduced to make KiwiSaver more attractive for employers to contribute towards their employees' savings for retirement, given that employer contributions could count towards the contribution rate of 4% or 8%. The exemption was also introduced to make it more attractive for employees to save, as their balance will grow more quickly with an employer subsidy that is not reduced by SSCWT.

Problem

4. The KiwiSaver legislation provides a number of mechanisms to support existing RSS including:

- the ability to convert to a KiwiSaver scheme;
- the ability to establish a KiwiSaver scheme under the umbrella of an existing superannuation trust deed; and
- the ability for employers with existing schemes that meet the requisite criteria to be exempt from the automatic enrolment rules.

5. From our discussions with ASFONZ we understand that, in the absence of the SSCWT exemption for KiwiSaver schemes, the following outcomes were likely:

- there was no need for existing RSS to compete with KiwiSaver schemes and both schemes would have co-existed;
- existing RSS would not have converted to KiwiSaver schemes due to the need to obtain 100% member support;

- most existing RSS would not have established a KiwiSaver scheme under an existing trust deed due to the start-up and on-going costs of setting up a new scheme. The on-going costs of having to administer two schemes with different administration processes and reporting requirements would be significant (for example, the KiwiSaver section would need to be administered via Inland Revenue's collection mechanism whereas the existing RSS would be administered using existing processes); and

- employers with existing schemes satisfying the requirements for the exemption from the automatic enrolment rules would likely have applied for this exemption and administered KiwiSaver for those employees who opted into KiwiSaver on a case by case basis.

6. In ASFONZ's opinion, the introduction of the SSCWT exemption for KiwiSaver schemes has changed how employers, members and providers of RSS will view KiwiSaver as its benefits are now greater.[1] The value of the exemption is on-going and is progressive. That is, the higher an employee's salary or wages and employer contribution, the higher the benefit. For example, the annual tax benefit of the exemption for employees earning $50,000 and $150,000 with employer contributions of 4% would be $660 a year and $1,980 a year respectively (based on a 33% SSCWT rate). The benefit of the $1,000 Government contribution and the fee subsidy pale over time in comparison to the benefit of the tax exemption. In addition, because many existing employer subsidies are more than 4%, a person can benefit from the full exemption without needing to change their savings behaviour.

7. The benefit of the exemption in relation to existing contributions is likely to accrue to the employee as the incidence of the SSCWT is in most cases borne by the employee[2] and their savings will grow more quickly with a tax-free employer subsidy.[3]

8. We understand from ASFONZ that the likely scenario if the exemption is not extended is:

- there will be pressure from employees on employers to access the benefits of tax-efficient savings offered by the KiwiSaver SSCWT exemption;

- employers with existing RSS will feel the need to offer access to KiwiSaver, ie run access to both a KiwiSaver scheme (to allow the employee to contribute 4% with a matched employer contribution) and its RSS (for any employee/employer contributions in excess of 4%);

- administering two schemes will result in the employer incurring higher compliance costs which is likely to result in the employer contemplating winding up their existing scheme and only offering a KiwiSaver scheme; and

[1] ASFONZ considered that while KiwiSaver provided benefits such as the $1,000 Government contribution and the fee subsidy, those benefits were not seen to outweigh the costs of extra lock-in and costs associated with converting or establishing KiwiSaver sections under the umbrella of an existing trust deed.
[2] In a tight labour market this is less likely to be the case as employers may be prepared to bear the incidence of SSCWT as a recruitment and/or retention tool.
[3] It is possible going forward that employers who choose to offer employer contributions may be able to extract some benefit of the exemption, such as giving a lower pay increase than otherwise would have been the case in return for employer contributions.

- wind-ups of existing RSS are likely to lead to leakage from existing retirement savings as anecdotal evidence suggests that some members will access and spend their savings rather than reinvesting them in another retirement savings vehicle.[4]

9. Officials do not have any evidence that contradicts the views expressed by ASFONZ. However, there may be other factors (such as the benefits of the existing rules regarding lock-in and non-portability of interests) that will result in employers continuing with their existing RSS. Furthermore, any winding up of RSS is likely to occur over the longer term, as the membership in such schemes declines due to employees joining KiwiSaver schemes. The introduction of KiwiSaver is in itself likely to result in the wind-up of some existing RSS over the long term, although wind-up may be accelerated if the exemption is not extended.

10. Overall officials consider that ASFONZ may have a valid concern but it is difficult to assess whether, or to what degree, it will eventuate.

Part one – proposed option to extend the KiwiSaver SSCWT exemption

11. The proposed option for extending the SSCWT exemption has been discussed with ASFONZ and is based around the approach briefly discussed between the Minister of Finance and ASFONZ. In general terms, a RSS would allow for accounts subject to the KiwiSaver lock-in rules to be administered within the existing trust deed.

12. The exemption would be subject to the same cap as employer contributions to a KiwiSaver scheme, ie the lesser of the employee's contribution to the scheme or 4% of the employee's salary or wages.

Summary of KiwiSaver features that would apply

13. The table below summarises the KiwiSaver features that would or would not apply under the proposed option:

KiwiSaver feature	**Required/applies under proposed option**
Minimum 4% contribution rate	✓
Lock-in until age 65 or 5 years of being a member, whichever is the later, except for: • first home ownership; • significant financial hardship; • serious illness; or • permanent emigration.	✓
Employer contributions vest based on trust deed or vest	✓

[4] The KiwiSaver Act 2006 amended the Superannuation Schemes Act 1989 to allow for transfers to another scheme without member consent to avoid leakage of savings when a scheme is wound up. However, the Superannuation Schemes Act does not override trust deeds and ASFONZ advises that most trust deeds do not permit the transfer of member funds without explicit member consent, which means members will be offered the option of withdrawing their savings.

KiwiSaver feature	**Required/applies under proposed option**
immediately if they count towards the minimum contribution rate.	
Provide statistical information about members	✓
Portability (funds remain locked-in when member changes job)	✓
Unable to borrow against the amount locked-in	✓
Full KiwiSaver reporting requirements	x
$1,000 kick-start Government contribution	x
Government fee subsidy	x
Housing deposit subsidy (if eligible)[5]	x
Requirement for an independent trustee	x
Contributions paid via Inland Revenue	x

Detail of proposed option

14. Trust deeds would allow an employee (member) to elect that contributions be subject to the following KiwiSaver rules, if the employee wished to avail themselves of the SSCWT exemption:

- As a minimum the KiwiSaver lock-in rules relating to withdrawals would apply and the scheme could not provide a more lenient withdrawal position. That is, lock-in until age 65 or five years of membership, whichever is longer, except for:
    - first home ownership;
    - significant financial hardship;
    - serious illness; or
    - permanent emigration.

- RSS could provide for more restricted withdrawal rules than KiwiSaver (such as no housing withdrawal).

- Contributions (both member and employer contributions) would be required to be transferred to a KiwiSaver scheme or another approved scheme, if the member ceases to be eligible to be a member of that scheme or otherwise ceases membership (for example, if they change jobs).[6]

- The minimum contribution rate to the locked-in account would be 4% of the employee's gross base salary or wages:[7]

[5] If the person's employer was exempt from the automatic enrolment rules the person would continue to be eligible for the housing deposit subsidy, provided they met the requisite criteria.
[6] The trust deed would require that such funds would have to be transferred to another scheme with similar lock-in when the employee ceases membership or ceases to be eligible to be a member (eg if they change employment), which is not the norm for employer-based schemes. While this would be similar in nature to an existing RSS establishing a KiwiSaver scheme under the umbrella of an existing trust deed, it would not impose on the employer and provider the requirements to administer two schemes (ie one under the Superannuation Schemes Act framework and another under the KiwiSaver Act framework with the associated duality of processes for the deduction and payment of contributions and reporting requirements).
[7] Under the proposed option, a minimum contribution of 4% of *gross base salary or wages* (ie gross salary or wages but excluding bonuses, overtime etc) would be required. Gross base salary or wages is the industry norm in deducting contributions and is the minimum

- o employer contribution could count towards this in the same manner as KiwiSaver contributions;
- o if such contributions count, the contributions have to vest immediately; and

- Members could not borrow against the amount that is subject to the KiwiSaver lock-in rules.

15. Funds already saved could continue to be subject to the scheme's normal withdrawal rules (ie the KiwiSaver lock-in rules would not need to apply to existing funds to be eligible for the exemption). The scheme would only need to subject those employee and employer contributions that count towards the amount exempted from SSCWT to the KiwiSaver lock-in rules. The remaining contributions could be subject to the scheme's normal withdrawal rules.

16. While nothing would prevent a scheme allowing for all contributions to be subject to the KiwiSaver lock-in rules, it is expected that employees would subject their funds to the KiwiSaver lock-in rules up to the maximum value of the exemption but not beyond ie any employee/employer contributions in excess of 4% would be subject to the scheme's normal withdrawal rules. The overall effect is likely to be a switch in savings that is already occurring to savings in a tax-preferred product (as opposed to an increase in net savings).

17. Below is an example of how the option is expected to work in practice:

Facts

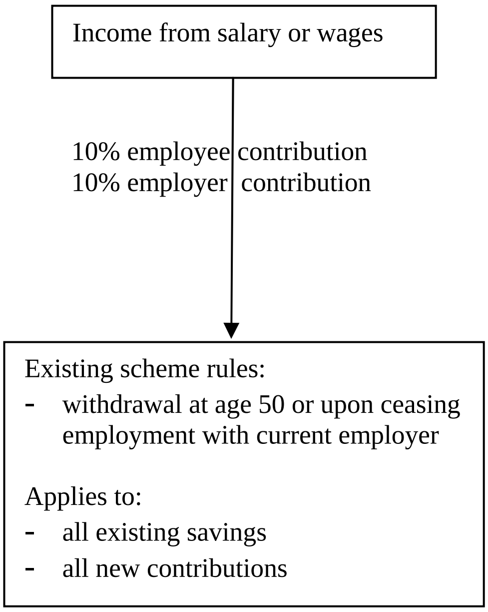
- Person A has been a member of employer-sponsored XYZ RSS for 10 years and has $100,000 invested.
- Person A contributes 10% of his income which is matched by a 10% employer contribution.
- Person A can withdraw his funds upon reaching age 50 or when he ceases employment with his current employer.

After SSCWT exemption

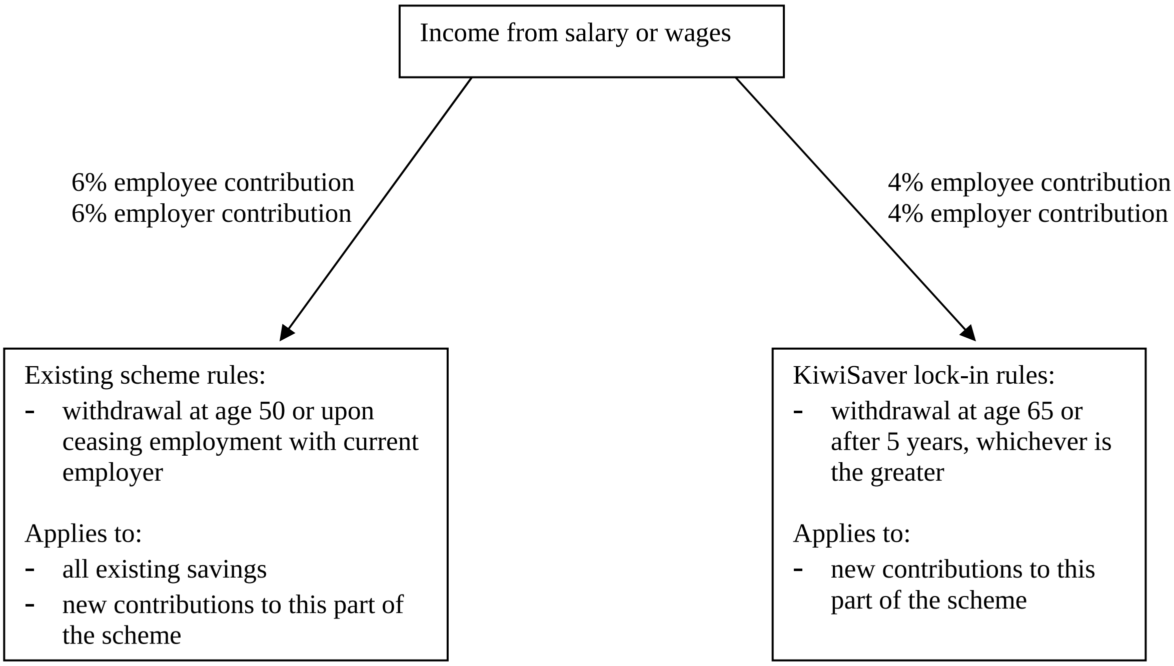
- XYZ changes its trust deed to allow for members' funds to be subject to the KiwiSaver lock-in rules.
- The funds invested to date would remain subject to the scheme's normal lock-in rules (ie withdrawal at age 50 or employment ceasing).
- Going forward, person A elects to have 4% of his income (employee contribution) and 4% employer contribution subject to the KiwiSaver lock-in rules to access the SSCWT exemption.
- The remainder of person A's contribution (6%) and the remainder of the employer contribution (6%) would continue to be subject to the scheme's normal lock-in rules.

contribution rate required for an employer to be exempt from the KiwiSaver automatic enrolment rules. For KiwiSaver purposes, *gross salary and wages* is used in calculating the minimum contribution rate.

Before SSCWT exemption



After SSCWT exemption



Further detailed design

18. Officials consider that for a RSS to be entitled to the SSCWT exemption it would need approval from the Government Actuary that the scheme meets the above criteria. This provides some monitoring and assurance that the criteria are met.[8]

19. The KiwiSaver Act requires that new KiwiSaver schemes (ie those that do not convert or establish a KiwiSaver section under an existing umbrella trust deed) have an independent trustee who is required to act in a professional capacity. Officials consider that there should be no requirement for approved RSS to have an independent trustee as existing RSS that convert or establish KiwiSaver schemes are not required to appoint an independent trustee. The wider issue of governance of superannuation schemes is being reviewed in the context of the review of financial products and providers.

20. KiwiSaver schemes also have additional reporting requirements. Officials consider that schemes approved for the exemption should be required to provide some statistical information in respect of the locked-in accounts as will be required from KiwiSaver schemes (this would not need to be as much as that required under KiwiSaver, nor would it be required to be audited). This is because such schemes will have KiwiSaver features and the Government should have information on a regular basis to assess the impact of the KiwiSaver initiative as a whole. ASFONZ considers such additional reporting would not be an issue as long as the additional information was provided as part of the current RSS reporting.

21. The proposed option would generate a one-off cost associated with amending the RSS trust deed so that it is compliant with the new lock-in requirements, system changes to operate two accounts (one with extra lock-in), amendments to investment statements to reflect the new offer, and wider communications and advice to members to ensure that they understand the offer. Officials understand that this cost would be similar to the costs associated with the establishment of a KiwiSaver scheme within the umbrella of an existing trust deed. However, there will not be significant additional ongoing costs for employers and providers in administering the scheme as existing processes will be used. On-going costs would be limited to the additional statistical reporting outlined in paragraph 20 and some additional administration costs of operating multiple accounts.

22. The $1,000 Government contribution and fee subsidy will not be payable in respect of members in existing RSS under the proposed option. However, if the locked-in contributions are transferred to a KiwiSaver scheme when an employee ceases to be a member of the RSS, the employee will become entitled to those Government subsidies from that time.

Impact on savings

23. The design of KiwiSaver is based around the behavioural economics literature that suggests some people do not save due to inertia; therefore KiwiSaver introduces the feature of automatic enrolment as a mechanism to encourage participation, particularly by those not

[8] The Government Actuary would not be required to monitor whether the criteria were met on an on-going basis but would have the ability to revoke approval on a retrospective basis if he or she became aware that a scheme no longer met the required criteria.

currently saving. In combination with the Government subsidies to KiwiSaver members, this was designed to encourage new saving and minimise the extent to which existing saving is subsidised, therefore minimising deadweight costs. The SSCWT exemption for KiwiSaver schemes has shifted the balance somewhat, and is likely to increase the degree to which existing saving is subsidised. Extending the SSCWT exemption as outlined above will further subsidise existing saving and is unlikely to encourage any additional saving.

24. Officials consider that the risk of wind-up of existing schemes should be weighed against the concern of an extension subsidising existing, as opposed to new, savings.

Boundary issues

25. The current SSCWT exemption creates a tax-preferred distortion for employees to save for their retirement via KiwiSaver. The preference for KiwiSaver schemes can be justified on the basis that savings are locked-in until the person reaches at least age 65 and are subject to its own regulatory regime, although other schemes may have similar characteristics. Extending the exemption to other RSS is moving that distortion to another class of savings vehicles which have similar characteristics.

26. Extending the exemption along the lines proposed by ASFONZ will not eliminate the distortions created by the tax exemption, as one class of savings vehicles will still be advantaged over another. There is a risk that the extension could increase the pressure from other groups for a similar tax incentive for contributions to similar schemes.[9] Officials consider this risk to be high. If the exemption was to be extended, officials consider that clear principles should be set to guide the boundaries of the extension, to help provide a defensible boundary against further demands for extensions. Principles for setting a boundary are outlined in part two of this report.

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[9] Pressure could be mitigated to a degree in that at least the exemption would apply equally to one class of vehicle.

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Department comments

34. Overall, the Treasury, Inland Revenue, and the Ministry of Economic Development consider that there are both risks and benefits of extending the SSCWT exemption. Different departments have reached different views on the relative magnitude of these risks and benefits, which leads to different views on the overall balance of risks. On balance, Inland Revenue considers that the exemption should not be extended (because of the associated boundary risks), while the Treasury and the Ministry of Economic Development consider that it should be extended (because of the risk of wind-up). Specific departmental comments are as follows:

The Treasury

35. The Treasury considers that there are a number of risks and distortions created by the current limited exemption: existing schemes may be wound up leading to leakage of savings;

efficiency costs if schemes are forced to convert to KiwiSaver for the sole purpose of seeking the tax exemption; and reduced competition for superannuation products outside of KiwiSaver. However, extending the exemption is unlikely to increase savings (existing savings will be subsidised). On balance, the Treasury considers that it is appropriate that the SSCWT exemption be extended to existing RSS that meet certain criteria (such as lock-in, portability, etc). However, given the costs of extending the SSCWT exemption, the extension should be weighed up against other priorities.

36. As with any tax exemption, distortions would remain, such as between the treatment of employee and employer contributions, the treatment of employees and the self-employed, and the treatment of different forms of saving. Therefore, extending the exemption in a limited way is unlikely to end the calls for further extensions, and some existing schemes are likely to be wound up even if the SSCWT exemption is extended. In order to mitigate further future risk, the Treasury recommends that clear boundaries are set and communicated about why the exemption has been extended to a new position, and why it would not be extended further in the future.

Inland Revenue

37. Inland Revenue recognises the issues raised by ASFONZ. However, on balance it considers the risks of widening the SSCWT exemption outweigh the concerns expressed by ASFONZ. The fiscal risks of a wide extension of the SSCWT exemption (and other KiwiSaver incentives) are very considerable.

Ministry of Economic Development

38. Officials from the Ministry of Economic Development believe that a failure to extend the exemption to existing schemes is likely to increase the incidence of leakage of funds from those schemes. Many employers will have the option of creating a KiwiSaver scheme that will bear all the features of their existing schemes. The members in those schemes will have the advantage of the fee subsidy, the kick-start contribution and the housing deposit subsidy, if applicable, in addition to the exemption from SSCWT. These employers are likely to want to access the KiwiSaver incentives and are unlikely to want to continue bearing costs of maintaining the existing scheme if they also set up a KiwiSaver scheme. The simplest option available to these employers is to wind-up their existing scheme and focus on providing a KiwiSaver scheme that bears the same features as their existing scheme. If employers choose this option, the effect is that most of the funds held by these schemes will be released back to members and potentially undermine the Government’s objective of encouraging savings. The option to extend the SSCWT exemption reduces this likelihood of leakage, by extending some of the KiwiSaver incentives to employers that currently offer an existing superannuation scheme. The option proposed in this paper ensures that such existing schemes adhere to KiwiSaver-like requirements, including lock-in and minimum contribution rates.

Part two – a principle-based approach for setting a boundary for the application of a tax exemption

39. If the SSCWT exemption is extended there will inevitably be calls for it to be extended further. This could be around the design of the SSCWT exemption itself, or calls for a tax exemption to apply more broadly than an SSCWT exemption (ie for an exemption to apply to contributions other than employer contributions). It is important that there is a firm boundary that communicates the circumstances under which a tax exemption is to apply.

40. Having a clear principle-based boundary will not only provide surety for public communications, comment and debate on any extension, but will also help to ensure that the integrity of the tax system is maintained. Officials recommend that the following principles be adopted to underlie setting the boundary for a tax exemption and be used in communications of any policy announcements:

Principle 1: Neutrality

41. The KiwiSaver SSCWT exemption creates a distortion in the market for superannuation funds as KiwiSaver is a tax-preferred investment. One reason for extending the exemption is to create a level playing field with products comparable to KiwiSaver. Officials believe that, in order to be comparable to the long-term savings component of KiwiSaver[11], a product should satisfy all the following criteria:

- have a minimum contribution rate of 4%;
- have lock-in rules that are no more lenient than the KiwiSaver lock-in rules;
- employer contributions vest based on trust deed or vest immediately if they count towards the employee's contribution rate;
- portability;
- members are unable to borrow against the funds in the locked-in account;
- a registered superannuation scheme;
- provide statistical information (although not at the full KiwiSaver requirement levels); and
- meet the portfolio investment entity criteria of having at least 20 non-associated members.

42. Employer contributions to one-person superannuation schemes, for example, would not meet this principle because such schemes do not have at least 20 non-associated members. The principle could also cover neutrality between structures, such as companies and the self-employed. This could imply that the self-employed should be eligible for an exemption. Further detail on schemes with less than 20 members and on the self-employed is outlined in appendix one.

[11] The mortgage diversion element of KiwiSaver is not included.

Principle 2: Guarding against the risk of leakage of existing superannuation savings

43. A primary purpose of extending the exemption is to reduce the risk of existing schemes winding up, distributing funds and those funds being spent rather than directed into new forms of long-term savings. This principle implies that a tax exemption should only be applied to employer contributions to existing schemes, as the risk of wind-up does not apply to a scheme not yet in existence.

44. This principle also implies that any tax exemption should apply to employer contributions to defined contribution schemes only, rather than extend to employer contributions to defined benefit schemes. As defined benefit schemes tend be older and closed to new members, the additional risk of wind-up in the KiwiSaver environment is negligible.

45. Further analysis on whether an exemption should apply to schemes not yet established and to defined benefit schemes is outlined in appendix one.

Principle 3: Encouraging employers to contribute to employees' savings

46. The policy aim behind the KiwiSaver SSCWT exemption was to support workplace saving by encouraging employers to contribute towards their employees' saving for their retirement.

47. This principle implies that contributions made by the self-employed should not be eligible for a tax exemption. Extending the exemption to such contributions would significantly change its landscape, as contributions made for a person's own benefit would become exempt from tax. This principle also implies that employee contributions should not be eligible for a tax exemption.

Principle 4: Reducing opportunities for tax avoidance

48. The wider a tax exemption is extended, the greater the risk that the integrity of the tax system will be undermined as the exemption is used as a way to minimise tax. Under this principle, a tax exemption should be implemented only if this can be done in a way that reduces opportunities for tax avoidance.

Recommendations arising from adopting principle-based approach

49. Using the above principles, officials recommend that a tax exemption:

- apply only to employer contributions to schemes that meet the portfolio investment entity criteria of having at least 20 non-associated members;

- apply only to employer contributions to schemes in existence when KiwiSaver is implemented (1 July 2007);
- apply only to employer contributions to defined contribution schemes (and not to defined benefit schemes); and
- apply only to employer contributions to registered superannuation schemes.

Contributions from the self-employed and employees

50. It is indefinite under the principles whether contributions from the self-employed should be eligible for a tax exemption (principle 1 could suggest that it should, while principle 3 could suggest that it should not). Principle 3 suggests that contributions from employees should not be exempt. A tax exemption for self-employed or employee contributions would likely involve allowing a deduction against taxable income. Further work would be required to design such a tax exemption as it may have administrative costs that have not been explored.

Fiscal costs

51. The table below summarises the estimated fiscal cost of extending the exemption as outlined above. It is assumed that no SSRSS member would elect for their savings that have a matched Government contribution to be subject to the KiwiSaver lock-in rules because the member would not directly benefit from the exemption under the current SSRSS offer. Therefore, the extension is assumed to have no fiscal cost in relation to SSCWT paid in respect of SSRSS members.

	$m – increase/(decrease)				
Vote Revenue Minister of Revenue	**2007/08**	**2008/09**	**2009/10**	**2010/11**	**2011/12& outyears**
Tax Revenue	(17)	(18)	(19)	(20)	(20)
Total	(17)	(18)	(19)	(20)	(20)

52. The assumptions underlying these costs are outlined in appendix two. The costs are highly sensitive to certain assumptions, particularly those relating to behaviour following the application of the exemption such as the number of members of existing RSS that would access the exemption. It is assumed that 40% of members of existing RSS will avail themselves of the exemption. The appendix also outlines the impact on the fiscal cost when certain sensitive assumptions are changed.

53.

Administrative costs

Inland Revenue

54. The administrative costs for Inland Revenue if the exemption is extended as outlined above will be minimal and will be funded out of existing baselines.

Government Actuary

55. The administrative costs for the Government Actuary to administer the exemption application process will likely be in the order of $0.150 million over the 2006/07 and the 2007/08 fiscal years, with no cost in out years. This is based on the following assumptions:

- A requirement for a consultant at the cost of $45,000 for 2006/07 and $50,000 for 2007/08. There will be additional administration costs to a maximum of $5,000 over 2006/07 and 2007/08.

- System changes to undertake the work, including modifications to the Government Actuary's databases and website at a maximum cost of $20,000.

- External legal advice in the order of $20,000 in 2006/07 and $10,000 in 2007/08.

56. It is envisaged that these costs will be partly third-party funded. The exercise of the function of approving schemes as having met the required criteria for the SSCWT exemption to apply will require the Government Actuary to review amendments made to RSS trust deeds. It is proposed that a $50 fee apply for this service. This is the same fee charged for the receiving of a trust deed amendment under the Superannuation Schemes Act 1989, pursuant to the Superannuation Schemes (Fees) Regulations 1992.

57. On the assumption of 2,000 applications being received by the Government Actuary over the 2006/07 and 2007/08 years (50% of these in 2006/07 and 50% in 2007/08) the forecast increase in third party revenue is $0.050 million in 2006/07 and a further $0.050 million in 2007/08. This will mean that a further $0.050 million in funding will be required. The attached Cabinet paper seeks to amend the current appropriation to enable the Government Actuary to effectively cover the cost of assessing the applications by schemes seeking the exemption.

58. The Government Actuary will reassess the funding and fee structures for all activities within its administration in 2007/08 to enable sufficient data to be collected on the Government Actuary's activities to ensure fee levels and funding streams are appropriately set.

Next steps – if Ministers wish to extend the exemption as outlined above

59. An extension of the SSCWT exemption will require amendments to the Income Tax Act and possibly the Superannuation Schemes Act and the KiwiSaver Act. If Ministers wish to proceed with extending the exemption based on the option outlined above, it is recommended that amendments be made by way of a Supplementary Order Paper (SOP) to the Taxation (Annual Rates, Savings Investment, and Miscellaneous Provisions) Bill at the Committee of the Whole House stage. We consider that such an SOP would comply with Standing Orders given that the Bill already contains amendments to the SSCWT rules in the Income Tax Act. This would allow the amendments to come into effect on 1 July 2007 – the date that KiwiSaver is implemented and the date from which the KiwiSaver SSCWT exemption will apply.

60. A draft Cabinet paper for the Cabinet Economic Development Committee (EDC) is attached for Ministers' consideration and referral. The timeline for making an amendment by way of an SOP is very tight – officials understand that the Committee of the Whole House stage of the Bill is planned for mid-December 2006. Therefore, the paper for EDC seeks approval for the Ministers of Finance and Revenue to be delegated authority to introduce an SOP. This means that drafting of an SOP would not need to be finalised before Cabinet could consider the policy change.

61. It is further recommended that a press statement announcing the policy change be drafted for release shortly after Cabinet has considered the proposal. The press statement would also communicate the principles for setting a boundary for a tax exemption, as outlined above.

62. Officials plan to release this report, and any associated Cabinet papers, on the Treasury website after any policy announcement is made.

Appendix one – Boundary at which to set a tax exemption

Application to schemes with less than 20 members

In the superannuation scheme environment there are a number of one-person schemes. These schemes are generally established by high net worth individuals, are less susceptible to regulatory monitoring and, as such, are able to arbitrage more readily. This is primarily because there are no checks and balances within the scheme, as would normally occur. The trustees, beneficiaries and issuer responsibilities are largely shared by the same person. Money invested through these schemes would be able to be released through provisions such as the hardship withdrawal, as these provisions would be administered by the beneficiary of the scheme, in his or her role as trustee.

To ensure that an incentive is not created for the establishment of such schemes, officials consider that the exemption should apply only to schemes that meet the portfolio investment entity criteria of having no less than 20 non-associated members. In the KiwiSaver environment, it is highly unlikely that schemes with less than 20 members would register as KiwiSaver schemes. KiwiSaver schemes are required to enter into scheme provider agreements and to set up electronic interfaces with Inland Revenue, which is likely to be a costly exercise that reduces the net benefit of setting up a one-person KiwiSaver scheme. Additional requirements such as the annual reporting and the requirement for an independent trustee are more likely to make one-person KiwiSaver schemes an unpalatable option.

Given that there is no requirement to enter into a scheme provider agreement with Inland Revenue in the superannuation environment, officials consider that this is a reasonable criteria to impose, to ensure competitive neutrality between KiwiSaver and the existing market.

Application to the self-employed

An SSCWT exemption cannot be applied to the self-employed because they do not pay SSCWT. If the tax exemption were to be extended to apply to contributions made by the self-employed, further work would be required as rules to allow a tax deduction for such contributions would need to be designed. Principle 1 could suggest that an exemption should apply as it could seek neutrality across different types of structures (for example, neutrality between companies and the self-employed). However, principle 3 could suggest that an exemption should not apply.

Application to new registered superannuation schemes

Officials raised the issue with ASFONZ as to whether the proposed option should be limited to existing RSS or whether it should also apply to RSS that are established in the future. ASFONZ considered that it would be preferable if it was not limited given that in relation to a KiwiSaver scheme that is established under an umbrella trust deed, members will be able to continue to contribute to the non-KiwiSaver scheme as well. Officials consider that the advantages and disadvantages of limiting the option to existing schemes are as follows:

Advantages of limiting exemption to existing schemes

- It will address the key issue identified by ASFONZ of helping to prevent the wind-up of existing schemes and leakage of existing savings. Extending the exemption to schemes established in a post-KiwiSaver environment is not necessary to achieve this goal; and
- it may provide a more defensible boundary in respect of calls for the exemption to be applied more widely.

Disadvantages of limiting exemption to existing schemes

- Going forward there could be a reduced incentive for new non-KiwiSaver schemes to open, which increases the monopoly for KiwiSaver and could reduce the ability for new and potentially innovative schemes to enter the market (although the status quo of limiting the SSCWT exemption to KiwiSaver may have this effect anyway).

On balance, officials consider that the exemption should be limited to existing schemes. Schemes established in the post-KiwiSaver environment are likely to include a KiwiSaver component so that they can compete with KiwiSaver. It could be argued that this results in a reduced incentive for new non-KiwiSaver schemes to open, increasing the monopoly for KiwiSaver, and reducing the ability for new and potentially innovative schemes to enter the market. All things considered, officials believe that competition will not be adversely affected. KiwiSaver will set a minimum standard for the development of new schemes and providers will be pushed to compete on other components of their product offering, such as service and fees, which has positive benefits for savers.

Application to defined benefit schemes

Under the KiwiSaver Act, a KiwiSaver scheme must be a defined contribution scheme which requires the contributions to be allocated on an individual basis. This means that employer contributions are allocated to an account in the name of the employee (member) and vest in the employee, subject to any vesting scale in the trust deed. However, with a defined benefit scheme employer contributions are made as required to ensure that the scheme can meet its current and expected liabilities. The contributions are not allocated to a specific employee as an employer contribution.

While an SSCWT exemption could potentially be adapted to deal with defined benefit schemes, officials consider that the likelihood of defined benefit schemes winding up due to not being eligible for the SSCWT tax exemption is low, given that the benefits accruing from membership of such schemes are likely to outweigh the benefits of the exemption. Officials consider that not extending an SSCWT exemption to defined benefit schemes will not affect the ageing of these schemes and the rate at which member numbers dwindle. Allowing an exemption to apply to defined benefit schemes would have further implications for the distribution of savings contributions. Under defined benefit schemes members' benefits are calculated on the length of contribution service and average salary. The salary portion of the calculation means that increases in employer contributions are often met with equal decreases in employee salary. This implies that a tax exemption would be passed on to the employee through a higher salary and not necessarily result in increased savings.

Application to superannuation schemes that are not registered

There is no requirement for superannuation schemes to register. A scheme may elect to provide retirement benefits in a superannuation framework without seeking registration with the Government Actuary. Most schemes that are not registered will be captured by the Unit Trusts Act, and will fall under the definition of a unit trust contained in that legislation. If a unit trust, however, meets the requirements proposed, it is highly likely that unit trust will also be eligible for registration as a superannuation scheme. The costs of registering a scheme are minimal.

The primary distinction between the two regimes is that the Government Actuary, as a regulator of superannuation schemes, has greater powers of investigation and intervention in the Superannuation Schemes Act. The Unit Trusts Act places most of the monitoring requirements on the trustees of the schemes. This is primarily because unit trusts have greater flexibility in their scheme design, whereas superannuation schemes have to be designed for the purpose of providing retirement benefits. As such, and given the minimal registration costs, officials believe that the more appropriate regulatory regime for schemes that comply with the criteria proposed is the Superannuation Schemes Act. Accordingly, officials recommend that the tax exemption apply only to employer contributions to registered superannuation schemes.

The review of non-bank financial products and providers that is currently being undertaken by the Ministry of Economic Development may change the distinction between registered superannuation schemes and superannuation schemes that are not registered. Because SSCWT applies only to employer contributions to registered superannuation schemes (employer contributions to schemes that are not registered are subject to fringe benefit tax), any changes to the superannuation regulatory framework would need to be considered from a tax perspective in terms of the application of SSCWT. The application of the tax exemption would also be considered at that stage.

Appendix two – Fiscal cost of extending of KiwiSaver SSCWT exemption to other RSS

Assumptions

Data sources

1. Superannuation schemes and membership data:
   - schemes and membership data are taken from the report of the Government Actuary and the report on the Government Superannuation Fund (GSF) Actuarial Valuation (active members only);
   - the schemes are grouped into two categories:
     i. employer-sponsored schemes which include SSRSS, GSF and private employer and other Government schemes; and
     ii. all other schemes (ie private and retail schemes) – it is assumed that no employer contributions are made to these schemes and therefore the exemption does not apply.

2. SSCWT collected by Inland Revenue is taken from the outturn reports. Forecasts of SSCWT are obtained from Inland Revenue forecasts in the 2006 Half Year Economic and Fiscal Update (HYEFU).

Scope

3. This costing covers only defined contribution schemes (excluding SSRSS) but does not include general defined benefit schemes or GSF schemes. It is assumed that no SSRSS member would elect that their contributions matched by the Government would be subject to the KiwiSaver lock-in rules and therefore there is no reduction in SSCWT in respect of SSRSS members.

Growth rates

4. Average historical membership growth rate is applied to each scheme to estimate the membership base to 2009/10 because it is considered that these growth rates are likely to continue in the future. That is, it is assumed that:
   - Employer-sponsored private and Government schemes are growing at 3% per year; and
   - deferred members and pensioners are declining at 3% per year.

5. Average wage growth is at 3.5%, taken from the KiwiSaver model.

Key behavioural assumptions and sensitivity analysis

6. There is a high level of uncertainty surrounding the assumption of how many members of employer-sponsored defined contribution schemes (excluding SSRSS members) will access the exemption. ASFONZ believes 10-30% of members of eligible schemes will

access the exemption, based on its past experience of the number of employees who take up the opportunity to use salary sacrifice to access the existing SSCWT benefits. ASFONZ and officials do not believe that all schemes will apply for the exemption because of the costs involved in amending trust deeds and not all members will access the exemption (due to factors such as the additional lock-in requirements associated with accessing the exemption). On balance, officials believe it is likely that around 40% of members of existing employer-sponsored RSS will access the exemption. Officials consider that take up will be higher than that predicted by ASFONZ because the benefits of the SSCWT exemption are significantly greater than is currently the case with salary sacrifice arrangements (salary sacrifice can provide a tax benefit of 6%, while the SSCWT exemption can provide a tax benefit of up to 39%). Officials believe that people will be more likely to access the exemption if they:

- are older (because they additional lock-in period is shorter);
- are high-income earners (because the higher the income, the greater the value of the exemption);
- have high existing balances (because they can access their existing balance under the existing scheme rules, which partially offsets the effect of stricter lock-in around future savings); and
- have not previously owned a home (because they can access the funds under the first home ownership withdrawal).

7. The following table shows the impact on the fiscal cost at various take-up rates:

Take up rate	Fiscal cost ($m)				Cumulative difference from base scenario over 4 years
	2007/08	2008/09	2009/10	2010/11+	
30%	13	14	14	15	-19
50%	22	23	24	25	19
60%	26	27	28	30	37
70%	30	32	33	35	56
80%	35	36	38	40	74
40%	**17**	**18**	**19**	**20**	**0**

8. It is assumed that all members access the full value of the exemption (ie at the 4% cap). In practice, not every member will get a 4% employer contribution. Due to the lack of distribution data, it is not possible to differentiate between groups with different employer contribution rates. Therefore, the costing assumes that of the 40% of defined contribution scheme members (excluding SSRSS members) who access the exemption, all will get the 4% exemption. This implicitly includes those members who will salary sacrifice up to 4% to get the full exemption benefit. As a result, the loss of PAYE revenue due to salary sacrifice has been implicitly included in the cost calculation.

9. If the SSCWT exemption is not extended, some members of existing schemes would likely have joined KiwiSaver to gain access to the SSCWT exemption. Therefore the costing needs to exclude these people (because they have already been counted in the KiwiSaver SSCWT exemption costs).

10. It is difficult to identify exactly how many of existing scheme members were implicitly included in the previous costings. The initial KiwiSaver model assumes that, on average, 16% of those who join KiwiSaver were already members of an existing scheme. However, this assumption was made before the KiwiSaver SSCWT exemption was introduced. Because the SSCWT exemption changed how members of existing RSS view KiwiSaver (ie KiwiSaver is more attractive to members of existing schemes) the model now assumes that 20% of those who join KiwiSaver were already members of an existing scheme. Because of the number of uncertain assumptions about the take-up of KiwiSaver, officials do not consider that the overall KiwiSaver take-up rate should be altered as a result of this change in assumption.

11. The KiwiSaver model does not make assumptions about the nature of that existing scheme and therefore whether the person would be able to access the SSCWT exemption through their existing scheme (existing schemes are a mix of retail and employer-sponsored and defined contribution and defined benefit schemes etc). ASFONZ considers that 25-50% of existing employer-sponsored defined contribution scheme members who take up the SSCWT exemption would otherwise have joined KiwiSaver to access the exemption. On balance, officials consider that around 70% of existing employer-sponsored defined contribution scheme members who take up the exemption would have joined KiwiSaver if the exemption was not extended. Because the compliance costs for an employee to join KiwiSaver are low, and employers are likely to want to remunerate their staff in a tax-efficient manner, officials consider that the majority of people who wish to access the exemption would otherwise have accessed it through KiwiSaver. However, this assumption is very uncertain.

12. The following table provides the sensitivity analysis on the rates of those members that otherwise would have joined KiwiSaver if the exemption was not extended (the double counting rate):

Double counting rate	**Fiscal cost ($m)**				**Cumulative difference from base scenario over 4 years**
	2007/08	**2008/09**	**2009/10**	**2010/11+**	
30%	41	42	44	46	99
40%	35	36	38	40	74
50%	29	30	32	33	50
60%	23	24	25	26	25
70%	**17**	**18**	**19**	**20**	**0**

13. We have not assumed a fiscal saving if these members remain in their existing scheme instead of joining KiwiSaver although the member will no longer receive the $1,000 and fee subsidy. This is because these members are likely to transfer to a KiwiSaver scheme when they change jobs, and so any fiscal saving will be a matter of timing.

14. It is assumed that the existing average employer contribution rate is 6.2% on average for non-SSRSS defined contribution schemes. This is based on figures from the ASFONZ 2003 Survey of Superannuation Schemes. However, the sample size for the survey was very small and therefore there is uncertainty about this rate. The rates are

highly sensitive as employers are contributing at varying rates for different members with varying incomes.

15. The assumption of the average employer contribution rate is important because the fiscal costs are estimated by determining the proportion of the current SSCWT base relevant to employer-sponsored defined contribution schemes that will be lost if the SSCWT exemption is extended. For example, if average employer contribution rates are currently 4%, this would imply that the entire SSCWT base could be lost, whereas if average employer contribution rates are currently 8%, the exemption would imply that 50% of the current SSCWT base could be lost.[12]

Implicit average employer contribution rate	**Fiscal cost ($m)**				**Cumulative difference from base scenario over 4 years**
	2007/08	**2008/09**	**2009/10**	**2010/11+**	
4%	27	28	29	31	40
5%	21	22	23	24	17
7%	14	15	16	17	-13
8%	13	14	15	15	-17
9%	12	12	13	14	-23
10%	11	11	12	12	-28
6%	**17**	**18**	**19**	**20**	**0**

16. ASFONZ raised the issue of whether the costings should take into account the effects of lost taxable investment income if existing RSS wind-up. If these second round effects were to be taken into account, any increase from GST resulting from consumption would also have to be taken into account. No assumptions have been made around this because of the uncertainty in predicting:

- the number of schemes that are likely to wind-up if the SSCWT exemption was not extended, solely as a result of the KiwiSaver SSCWT exemption;
- the value of the funds held under management by such schemes; and
- the behavioural impact in terms of the money that is likely to be spent/re-invested in similar savings products if schemes are wound up.

17. The fiscal costs are based on the SSCWT collected by Inland Revenue. The SSCWT is apportioned to the amount attributed to non-SSRSS defined contribution scheme members. The fiscal costs are then calculated by applying the assumptions outlined above.

[12] Because an average employer contribution rate of over 4% is assumed, the costing implicitly takes into account the costs associated with forgone PAYE in respect of those members who use salary sacrifice to maximise the value of the exemption (see paragraph 8 of this appendix).

OFFICE OF THE MINISTER OF FINANCE
AND OFFICE OF THE MINISTER OF REVENUE

Chair
Cabinet Economic Development Committee

EXTENDING THE KIWISAVER SSCWT EXEMPTION TO OTHER REGISTERED SUPERANNUATION SCHEMES

PROPOSAL

1. This paper proposes that the tax exemption afforded to employer contributions to KiwiSaver schemes be extended to employer contributions to other registered superannuation schemes (RSS).

EXECUTIVE SUMMARY

2. Changes introduced earlier this year exempt employer contributions to KiwiSaver schemes from specified superannuation contribution withholding tax (SSCWT), subject to a cap.

3. The tax exemption is currently limited to employer contributions to KiwiSaver schemes. Because KiwiSaver is a more tax-efficient means of remunerating staff, there is a risk that existing employer-sponsored schemes will wind-up with the subsequent distribution of savings from those schemes. This could potentially undermine the Government's objective of increasing savings.

4. It is therefore recommended that the KiwiSaver SSCWT exemption be extended to employer contributions to other RSS. In general terms, a RSS would have to allow for accounts subject to the KiwiSaver lock-in rules to be administered within the existing trust deed of the scheme. The exemption would be subject to the same cap as employer contributions to KiwiSaver.

5. It is recommended that amendments to give effect to the changes be made by way of a Supplementary Order Paper (SOP) to the Taxation (Annual Rates, Savings, Investment, and Miscellaneous Provisions) Bill at the Committee of the Whole House stage. This would allow the amendments to come into effect on 1 July 2007 – the date that KiwiSaver is implemented. You are asked to delegate authority to the Ministers of Finance and Revenue to introduce such an SOP.

BACKGROUND

6. An exemption from SSCWT for employer contributions to KiwiSaver schemes was introduced to make it more attractive for employers to contribute towards their employees' saving for retirement. In addition, the exemption was introduced to make it more attractive

for employees to save, as their balance will grow more quickly with an employer subsidy that is not reduced by SSCWT. The exemption is subject to a cap of the lesser of the employee's contribution or 4% of the employee's salary or wages.

7. Representatives of the superannuation industry have raised concerns with us that the existing exemption creates distortions because KiwiSaver is a tax-preferred investment. This may lead to the winding up of existing schemes to which employers contribute and the subsequent distribution of savings from those schemes.

PROBLEM

8. The introduction of the SSCWT exemption has changed how employers, providers and members of existing RSS view KiwiSaver as its benefits are now greater. The value of the exemption is ongoing and progressive – the higher an employee's salary or wages and employer contribution, the higher the benefit. For example, the annual tax benefit of the exemption for employees earning $50,000 and $150,000 with employer contributions of 4% would be $660 a year and $1,980 a year respectively.[13] The benefit of the $1,000 Government contribution to KiwiSaver and the fee subsidy pale over time in comparison to the benefit of the tax exemption.

9. We understand that the likely scenario if the SSCWT exemption is not extended is:

- there will be pressure from employees on employers to access the benefits of tax-efficient savings offered by the KiwiSaver SSCWT exemption;
- employers with existing RSS will feel the need to offer access to KiwiSaver, ie run access to both a KiwiSaver scheme (to allow the employee to contribute 4% to KiwiSaver with a matched employer contribution) and its RSS (for any contribution in excess of 4%)[14];
- administering two schemes will result in the employer incurring higher compliance costs which is likely to result in the employer contemplating winding up their existing scheme and only offering a KiwiSaver scheme; and
- wind-ups of existing RSS are likely to lead to leakage from existing retirement savings as anecdotal evidence suggests that some members will access and spend their savings rather than reinvesting them in another retirement savings vehicle.

10. If existing RSS wind-up, the Government's objective of increasing savings could potentially be undermined.[15]

PROPOSAL

11. Because of the risk of wind-up, we recommend that the KiwiSaver SSCWT exemption be extended to employer contributions to other RSS. The exemption would be subject to the

[13] Based on a 33% SSCWT rate.
[14] Any contributions in excess of the cap are likely to be directed towards the existing scheme because the lock-in rules are likely to be more lenient than the KiwiSaver lock-in rules.
[15] At the very least, if existing RSS wind-up there will be a perception (at least initially) that the objective of encouraging savings is being undermined.

same cap as employer contributions to a KiwiSaver scheme (the lesser of the employee's contribution or 4% of the employee's salary or wages). Under the proposed option, a RSS would have to allow for accounts subject to the KiwiSaver lock-in rules to be administered within the existing trust deed.

Detail of option

12. For employer contributions to be exempt from SSCWT, the trust deed of the scheme would have to be amended to allow contributions to be subject to certain criteria. If an employee (member) wished to avail themselves of the SSCWT exemption, they would then have to elect that employee and employer contributions are subject to those criteria.

13. For the SSCWT exemption to apply, the following criteria would have to be met:

- At a minimum, the KiwiSaver lock-in rules relating to withdrawals apply (ie the scheme could not provide a more lenient withdrawal position). That is, lock-in until age 65 or five years of membership, whichever is longer, except for:
  - first home ownership;
  - significant financial hardship;
  - serious illness; or
  - permanent emigration.
- Contributions are required to be transferred to a KiwiSaver scheme or another approved scheme if the member ceased to be eligible to be a member of their existing scheme or otherwise ceases membership (for example, if they changed jobs).
- As is the case with KiwiSaver, the minimum contribution rate to the locked-in account would be 4% of the employee's gross base salary or wages and:
  - employer contributions could count towards this rate; and
  - if such contributions count, they have to vest immediately.
- Members could not borrow against the amount locked-in (as is the case with KiwiSaver).

14. Funds already saved could continue to be subject to the scheme's normal withdrawal rules (ie the KiwiSaver lock-in rules would not need to apply to existing savings to be eligible for the exemption). The scheme would only need to subject those employee and employer contributions that counted towards the amount exempted from SSCWT to the KiwiSaver lock-in rules. The remaining contributions could be subject to the scheme's normal withdrawal rules.

15. While nothing would prevent a scheme allowing for all contributions to be subject to the KiwiSaver lock-in rules, it is expected that employees would subject their funds to the KiwiSaver lock-in rules up to the maximum value of the exemption but not beyond ie any employee/employer contribution in excess of 4% would be subject to the scheme's normal

withdrawal rules. The overall effect is likely to be a switch in savings already occurring to savings in a tax-preferred product (as opposed to an increase in net savings).

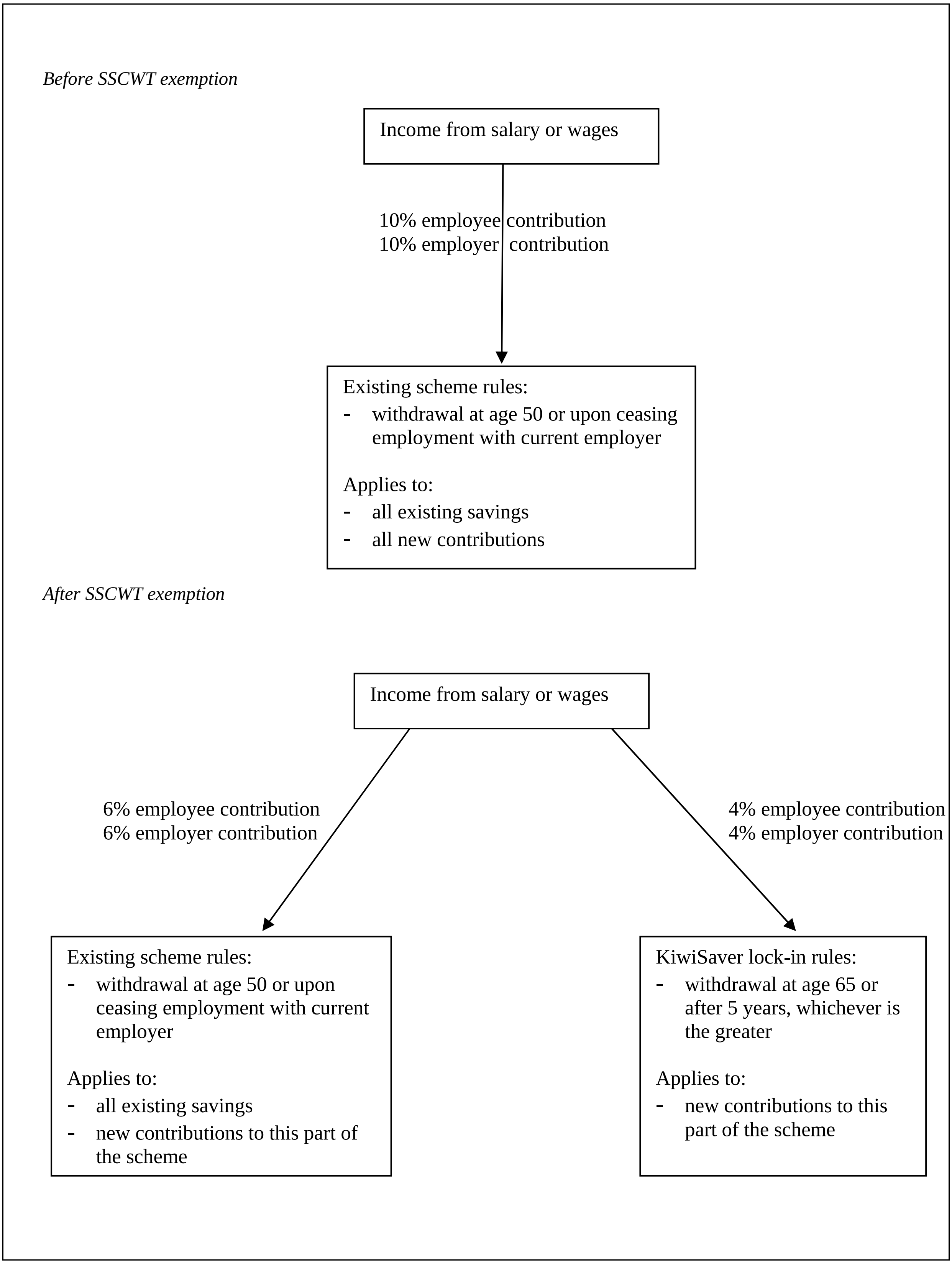
16. Below is an example of how the option is expected to work in practice:

Facts

- Person A has been a member of employer-sponsored XYZ RSS for 10 years and has $100,000 invested.
- Person A contributes 10% of his income which is matched by a 10% employer contribution.
- Person A can withdraw his funds upon reaching age 50 or when he ceases employment with his current employer.

After SSCWT exemption

- XYZ changes its trust deed to allow for members' funds to be subject to the KiwiSaver lock-in rules.
- The funds invested to date would remain subject to the scheme's normal lock-in rules (ie withdrawal at age 50 or employment ceasing).
- Going forward, person A elects to have 4% of his income (employee contribution) and 4% employer contribution subject to the KiwiSaver lock-in rules to access the SSCWT exemption.
- The remainder of person A's contribution (6%) and the remainder of the employer contribution (6%) would continue to be subject to the scheme's normal lock-in rules.



17. It is further recommended that for a RSS to be entitled to the SSCWT exemption it must:

- provide certain statistical information in respect of the locked-in accounts so that the Government can assess the impact of the KiwiSaver initiative as a whole; and

- obtain approval from the Government Actuary that the scheme meets the required criteria. This provides some assurance that the criteria have been met.[16]

18. The $1,000 Government contribution and fee subsidy will not be payable in respect of existing RSS members under the proposal. However, if the locked-in contributions are transferred to a KiwiSaver scheme when an employee ceases to be a member of the RSS, the employee will become entitled to those Government subsidies from that time.

A PRINCIPLE-BASED APPROACH FOR SETTING A BOUNDARY FOR THE APPLICATION OF A TAX EXEMPTION

19. If the SSCWT exemption is extended there will inevitably be calls for it to be extended further. This could be around the design of the SSCWT exemption itself, or calls for a tax exemption to apply more broadly than an SSCWT exemption (ie for an exemption to apply to contributions other than employer contributions). It is important that there is a firm boundary that communicates the circumstances under which a tax exemption is to apply.

20. We recommend that the following principles be adopted to underlie setting the boundary for a tax exemption and be used in communications of any policy announcements:

Principle 1: Neutrality

21. The KiwiSaver SSCWT exemption creates a distortion in the market for superannuation funds as KiwiSaver is a tax-preferred investment. One reason for extending the exemption is to create a level playing field with products comparable to KiwiSaver. This principle implies that the following criteria should be satisfied in order for a scheme to be eligible for a tax exemption:

- a minimum contribution rate of 4%;
- lock-in rules that are no more lenient than the KiwiSaver lock-in rules;
- employer contributions vest based on trust deed or vest immediately if they count towards the employee's contribution rate;
- portability;
- members are unable to borrow against the funds in the locked-in account;
- a registered superannuation scheme;
- provide statistical information (although not at the full KiwiSaver requirement levels); and
- be a scheme that has at least 20 non-associated individual members.

22. Employer contributions to one-person superannuation schemes, for example, would not meet this principle because such schemes do not have at least 20 non-associated members.

[16] The Government Actuary would not be required to monitor whether the criteria were met on an on-going basis but would have the ability to revoke approval on a retrospective basis if he or she became aware that a scheme no longer met the required criteria.

The principle could also cover neutrality between structures, such as companies and the self-employed.

Principle 2: Guarding against the risk of leakage of existing superannuation savings

23. A primary purpose of extending the exemption is to reduce the risk of existing schemes winding up, distributing funds and funds being spent rather than directed into new forms of long-term savings. This principle implies that a tax exemption should only be applied to employer contributions to existing schemes, as the risk of wind-up does not apply to a scheme not yet in existence.

24. This principle also implies that any tax exemption should apply to employer contributions to defined contribution schemes only, rather than extend to employer contributions to defined benefit schemes. As defined benefit schemes tend be older and closed to new members, the additional risk of wind-up in the KiwiSaver environment is negligible.

Principle 3: Encouraging employers to contribute to employees' savings

25. The policy aim behind introducing the KiwiSaver SSCWT exemption was to support workplace saving by encouraging employers to contribute towards their employees' savings for retirement.

26. This principle implies that contributions made by the self-employed should not be eligible for a tax exemption. Extending an exemption to such contributions would significantly change its landscape, as contributions made for a person's own benefit would become exempt from tax. This principle also implies that employee contributions should not be eligible for a tax exemption.

Principle 4: Reducing opportunities for tax avoidance

27. The wider a tax exemption is extended, the greater the risk that the integrity of the tax system will be undermined as the exemption is used as a way to minimise tax. Under this principle, a tax exemption should be implemented only if this can be done in a way that reduces opportunities for tax avoidance.

Recommendations arising from adopting principle-based approach

28. Using the above principles, we recommend that a tax exemption:

- apply only to employer contributions to schemes that have at least 20 non-associated members;

- apply only to employer contributions to schemes in existence when KiwiSaver is implemented (1 July 2007);
- apply only to employer contributions to defined contribution schemes (and not to defined benefit schemes); and
- apply only to employer contributions to superannuation schemes that are registered superannuation schemes.

Contributions from the self-employed and employees

29. It is indefinite under the principles whether contributions from the self-employed should be eligible for a tax exemption (principle 1 could suggest that it does, while principle 3 could suggest that it does not). Principle 3 suggests that contributions from employees should not be exempt. A tax exemption for self-employed or employee contributions would likely involve allowing a deduction against taxable income. Further work would be required to design such a tax exemption as it may have administrative costs that have not been explored.

ADMINISTRATIVE COSTS

Inland Revenue

30. The administration costs for Inland Revenue are minimal and these will be funded out of existing baselines.

Government Actuary

63. The administrative costs for the Government Actuary to administer the exemption application process will likely be in the order of $0.150 million over the 2006/07 and the 2007/08 fiscal years, with no cost in out years. This is based on the following assumptions:

- A requirement for a consultant at the cost of $45,000 for 2006/07 and $50,000 for 2007/08. There will be additional administration costs to a maximum of $5,000 over 2006/07 and 2007/08.
- System changes to undertake the work, including modifications to the Government Actuary's databases and website at a maximum cost of $20,000.
- External legal advice in the order of $20,000 in 2006/07 and $10,000 in 2007/08.

64. It is envisaged that these costs will be partly third-party funded. The exercise of the function of approving schemes as having met the required criteria for the SSCWT exemption to apply will require the Government Actuary to review amendments made to RSS trust deeds. It is proposed that a $50 fee apply for this service. This is the same fee charged for

the receiving of a trust deed amendment under the Superannuation Schemes Act 1989, pursuant to the Superannuation Schemes (Fees) Regulations 1992.

65. On the assumption of 2,000 applications being received by the Government Actuary over the 2006/07 and 2007/08 years (50% of these in 2006/07 and 50% in 2007/08) the forecast increase in third party revenue is $0.050 million in 2006/07 and a further $0.050 million in 2007/08. This will mean that a further $0.050 million in funding will be required.

66. You are asked to approve the following changes to appropriations to implement the proposal and enable the Government Actuary to recover the costs of processing applications for exemptions for tax exemptions with a corresponding impact on the operating balance:

	$m – increase/(decrease)				
Vote Commerce Minister of Commerce	**2006/07**	**2007/08**	**2008/09**	**2009/10**	**2010/11& outyears**
Departmental Output Expense: Registration and Provision of Statutory Information (funded by revenue Other)	0.088	0.062	-	-	-
Departmental Output Expense: Registration and Provision of Statutory Information (funded by revenue Crown)	0.025	0.025	-	-	-

67. You are asked to agree that the changes to appropriations for 2006/07 above be included in the 2006/07 Supplementary Estimates and that, in the interim, these expenses be met from Imprest Supply.

68. The Government Actuary will reassess the funding and fee structures for all activities within its administration in 2007/08 to enable sufficient data to be collected on the Government Actuary's activities to ensure fee levels and funding streams are appropriately set.

FISCAL IMPLICATIONS

31. It is estimated that the proposal will have the following fiscal cost:

	$m – increase/(decrease)				
Vote Revenue Minister of Revenue	**2007/08**	**2008/09**	**2009/10**	**2010/11**	**2011/12& outyears**
Tax Revenue	(17)	(18)	(19)	(20)	(20)
Total	(17)	(18)	(19)	(20)	(20)

32. The assumptions underlying the fiscal cost are highly sensitive to particular assumptions, particularly those relating to behaviour following the application of the exemption, such as the number of members of existing RSS that would access the exemption

and the number of members that would have joined KiwiSaver if the exemption was not extended.

33.

LEGISLATIVE REQUIREMENTS

34. We recommend that legislation to give effect to the above proposals be included in a Supplementary Order Paper (SOP) to the Taxation (Annual Rates, Savings Investment, and Miscellaneous Provisions) Bill at the Committee of the Whole House stage. This would allow the amendments to come into effect on 1 July 2007 – the date that KiwiSaver is implemented and the date from which the KiwiSaver SSCWT exemption will apply – and would give schemes sufficient time to amend their trust deeds.

35. The Committee of the Whole House stage of the Bill is planned for mid-December 2006. Given the short timeframe, it is recommended that the Ministers of Finance and Revenue be delegated authority to introduce an SOP, without the need for a separate paper to be considered by the Cabinet Legislation Committee.

REGULATORY IMPACT STATEMENT

36. A Regulatory Impact Statement (RIS) and Business Compliance Cost Statement (BCCS) are attached that comply with the requirements for RISs and BCCSs as set out in Cabinet Office Circular CO (04) 4. The BCCS states that there will be increased compliance costs for business where the trust deed of a scheme is amended to provide access to the SSCWT exemption; for schemes where the trust deed is not amended, no compliance costs are imposed.

37. Based on the information provided in the attached RIS/BCCS, the Regulatory Impact Analysis Unit considers that the disclosure of information is adequate, and the level of analysis is appropriate given the likely impacts of the proposal.

HUMAN RIGHTS IMPLICATIONS

38. The proposals in this paper appear to be consistent with the rights and freedoms affirmed in the New Zealand Bill of Rights Act 1990 and the Human Rights Act 1993. A final view will be possible after the amendments are drafted for inclusion in an SOP.

PUBLICITY

39. We plan to release a press statement announcing the changes shortly after Cabinet has considered the proposal.

CONSULTATION

40. Inland Revenue, the Treasury, the Ministry of Economic Development and the Ministry of Justice have been consulted in the preparation of this paper.

RECOMMENDATIONS

41. We recommend that the Committee:

1. **Agree** that the KiwiSaver SSCWT exemption be extended to employer contributions to other registered superannuation schemes that satisfy the following design features:
    - as a minimum, the KiwiSaver Scheme rules relating to withdrawals apply and more lenient withdrawal provisions not be permitted. That is, that funds are locked-in until age 65 or five years of membership, whichever is the later, except for:
        - first home ownership;
        - significant financial hardship;
        - serious illness; or
        - permanent emigration;
    - the minimum contribution rate to the locked-in account is 4% of the employee's gross base salary or wages; and
        - employer contributions can count towards this;
        - if such contributions count, the contributions have to vest immediately;
    - members be unable to borrow against the amount locked-in;
    - contributions (both member and employer) in the locked-in account are required to be transferred to a KiwiSaver scheme or another approved scheme, if the member ceases to be eligible to be a member of that scheme or otherwise ceases membership; and
    - only those future employee and employer contributions that count towards the amount exempted from SSCWT are required to be subject to the KiwiSaver lock-in rules.

2. **Agree** that the exemption apply up to a cap of the lesser of the employee's contribution to the scheme or 4% of the employee's salary or wages.

3. **Agree** that the exemption apply only to employer contributions to schemes that have at least 20 non-associated members.

4. **Agree** that the exemption apply only to employer contributions to schemes in existence when KiwiSaver is implemented (1 July 2007).

5. **Agree** that the exemption apply only to employer contributions to defined contribution schemes.

6. **Agree** that a tax exemption apply only to employer contributions to registered superannuation schemes.

7. **Agree** that for employer contributions to be eligible for the exemption, the Government Actuary must approve the scheme as having met the criteria in recommendations 1-6.

8. **Agree** that if there are calls for an exemption to apply more broadly than the circumstances described in recommendations (1) – (6) the following principles be communicated as the circumstances under which a tax exemption should apply:

   - Principle 1: Neutrality
   - Principle 2: Guarding against the risk of leakage of existing superannuation savings
   - Principle 3: Encouraging employers to contribute to employees' savings
   - Principle 4: Reducing opportunities for tax avoidance

9. **Note** that it is indefinite under the principles whether a tax exemption should apply to contributions made by the self-employed and that any application of a tax exemption to contributions made by the self-employed or employees would require further work.

10. **Approve** the following changes to appropriations to implement the proposal in recommendation (1) – (7) and enable the Government Actuary to recover the costs of processing applications for exemptions for tax exemptions with a corresponding impact on the operating balance:

	$m – increase/(decrease)				
Vote Commerce **Minister of Commerce**	**2006/07**	**2007/08**	**2008/09**	**2009/10**	**2010/11& Outyears**
Departmental Output Expense: Registration and Provision of Statutory Information (funded by revenue Other)	0.088	0.062	-	-	-
Departmental Output Expense: Registration and Provision of Statutory Information (funded by revenue Crown)	0.025	0.025	-	-	-

11. **Agree** that the changes to appropriations for 2006/07 above be included in the 2006/07 Supplementary Estimates and that, in the interim, these expenses be met from Imprest Supply.

12. **Note** that the Government Actuary will undertake a review of the funding and fee structures for all activities within its administration in 2007/08.

13. **Note that** it is estimated that extending the SSCWT exemption as outlined in recommendations (1) – (6) would have the following fiscal costs, and that these costs are sensitive to a number of assumptions:

	$m – increase/(decrease)				
Vote Revenue Minister of Revenue	**2007/08**	**2008/09**	**2009/10**	**2010/11**	**2011/12& outyears**
Tax Revenue	(17)	(18)	(19)	(20)	(20)
Total	(17)	(18)	(19)	(20)	(20)

14.

15. **Agree** that amendments be made to give effect to the above recommendations by way of a Supplementary Order Paper to the Taxation (Annual Rates, Savings, Investment, and Miscellaneous Provisions) Bill at the Committee of the Whole House stage of the Bill.

16. **Agree** that the Ministers of Finance and Revenue be delegated authority to introduce a Supplementary Order Paper without the need for a separate paper to be considered by the Cabinet Legislation Committee.

17. **Agree** that a press statement to announce the policy change be released after Cabinet has considered the proposal.

Hon Dr Michael Cullen
Minister of Finance

Hon Peter Dunne
Minister of Revenue

REGULATORY IMPACT STATEMENT

Statement of the nature and magnitude of the problem and the need for Government action

Employer contributions to KiwiSaver schemes (ie schemes registered in the KiwiSaver schemes register) are exempt from specified superannuation contribution withholding tax (SSCWT), subject to a cap. SSCWT is payable on contributions made by an employer to a registered superannuation scheme (RSS) on behalf of their employee.

The SSCWT exemption – introduced near the end of the Parliamentary process of the KiwiSaver Act – has changed how employees, employers and scheme providers view KiwiSaver as its benefits are now greater. The value of the exemption is ongoing and progressive – the higher an employee's salary or wages and employer contribution, the higher the benefit. For example, the annual tax benefit of the exemption for an employee earning $50,000 with employer contributions of 4% would be $660 a year (based on a 33% SSCWT rate). The benefits of the $1,000 Government contribution to KiwiSaver and the fee subsidy paid to members' KiwiSaver schemes pales over time in comparison to the benefit of the tax exemption.

As a result of the SSCWT exemption distortions are created because KiwiSaver is a tax-preferred investment. The likely scenario if the exemption is not extended is:

- there will be pressure from employees on employers to access the benefits of tax-efficient savings offered by the KiwiSaver SSCWT exemption;
- employers with existing RSS will feel the need to offer access to KiwiSaver, ie run access to both a KiwiSaver scheme (to allow the employee to contribute 4% to KiwiSaver with a matched employer contribution) and its RSS (for any contribution in excess of 4%);
- administering two schemes will result in the employer incurring higher compliance costs which is likely to result in the employer contemplating winding up their existing scheme and only offering a KiwiSaver scheme; and
- wind-ups of existing RSS are likely to lead to leakage from existing retirement savings as anecdotal evidence suggests that some members will access and spend their savings rather than reinvesting them in another retirement savings vehicle. This would be contrary to the Government's objective of increasing savings.

Statement of the public policy objectives(s)

The policy objective is to ensure that existing savings are not compromised as a result of the introduction of KiwiSaver.

Statement of feasible options (regulatory and/or non-regulatory) that may constitute viable means for achieving the desired objective(s)

Status quo – Tax exemption for employer contributions to KiwiSaver schemes

Employer contributions to a KiwiSaver scheme are exempt from SSCWT subject to a cap, the lesser of the employee's contribution or 4% of the employee's salary or wages. Employer contributions to non-KiwiSaver RSS are not exempt from tax.

The tax exemption for employer contributions comes into effect on 1 July 2007, the date that KiwiSaver is implemented.

Preferred option – Extend the KiwiSaver SSCWT exemption to employer contributions to other RSS

The preferred option is to extend the KiwiSaver SSCWT exemption to employer contributions to other RSS, to come into effect on 1 July 2007. In general terms, this would be achieved by a RSS allowing a separate account subject to the KiwiSaver lock-in rules to be administered within the existing trust deed of the scheme. That is, lock-in until age 65 or five years of membership, whichever is longer, except for:

- first home ownership;
- significant financial hardship;
- serious illness; or
- permanent emigration.

An employee would have to elect that their funds were subject to the KiwiSaver lock-in rules to access the exemption. The minimum contribution to the account with the KiwiSaver lock-in rules would be 4% of the employee's salary or wages (employer contributions could count towards this).

The exemption would be subject to the same cap as the exemption for employer contributions to KiwiSaver. The Government Actuary would have to approve a scheme as having met the required criteria to be eligible for the exemption. The RSS would need to provide statistical information to the Government Actuary about the scheme on an on-going basis.

Statement of the net benefit of the proposal, including the total regulatory costs (administrative, compliance and economic costs) and benefits (including non-quantifiable benefits) of the proposal, and other feasible options

Government

The benefit to the Government of adopting the preferred option is to lessen the likelihood of existing RSS winding up (because distortions between KiwiSaver schemes and other RSS have been reduced) and the subsequent distribution of savings from those schemes – ensuring that existing savings are not compromised as a result of the introduction of KiwiSaver.

The estimated fiscal costs of the proposals (in revenue forgone) are $17 million in 2007/08, $18 million in 2008/09 and $20 million in 2009/10.

The estimated administration costs to the Government Actuary of the proposals are $0.185 million in 2006/07 and 2007/08. The administration costs to Inland Revenue will be minimal.

Business

The benefit to scheme providers and employers in adopting the preferred option is that existing employer-sponsored schemes can remain viable. In addition, employers will be able to remunerate their staff in a more tax-efficient manner. There is an impact on business compliance costs which is discussed in the Business Compliance Cost Statement – there will be compliance costs for business where the trust deed of a scheme is amended; for schemes where the trust deed is not amended, no compliance costs are imposed.

Employees/members

The benefit to employees of adopting the preferred option is that their savings balance will grow faster as employer contributions will not be eroded by tax (provided that the employer contribution is paid gross of tax). Employees will also be able to access the tax exemption by remaining in their existing scheme.

Society

The benefit to society of adopting the preferred option is neutrality between KiwiSaver and other registered superannuation schemes. In addition, aggregate savings will not decrease (given that under the status quo is a greater risk of existing savings being spent).

Statement of consultation undertaken

Government agencies

Inland Revenue, the Treasury, the Ministry of Economic Development, the State Services Commission and the Ministry of Justice have been consulted in the preparation of this report and no significant concerns were raised.

BUSINESS COMPLIANCE COST STATEMENT

It would not be a requirement for registered superannuation schemes (RSS) to offer access to the tax exemption. Schemes will have to amend their trust deed for the exemption to apply. For those that wanted to, the proposal would generate the following one-off costs to schemes:

- the legal costs associated with amending the trust deed of the RSS so that it is compliant with the new lock-in requirements;
- systems changes to operate two accounts (one with the KiwiSaver lock-in rules and the other with the existing scheme lock-in rules);
- amendments to investment statements to reflect the new offer; and
- wider communications and advice to members to ensure that they understand the offer.

The Association of Superannuation Funds of New Zealand (ASFONZ) consider that the one-off costs would be similar to the costs associated with establishing a KiwiSaver scheme within the umbrella of an existing trust deed (approximately $50,000).

There would be some ongoing costs involved in the additional statistical reporting would be required (in respect of the funds subject to the KiwiSaver lock-in rules) and in the costs of operating multiple accounts. These costs would not be significant for employers and providers as existing processes would be used.

There are currently 157 employer-sponsored defined contribution schemes that the exemption could apply to. There are 208,790 members in these schemes with $327 million in funds under management. However, not all schemes are expected to amend their trust deeds – this is because the costs in doing so are likely to outweigh the benefits of offering access to the tax exemption – particularly for those schemes with small numbers of members.

Details of the changes will be provided on the websites of the Treasury, Inland Revenue and the Ministry of Economic Development. Inland Revenue will also update its publications to employers and will publish information about the changes in its *Tax Information Bulletin* following enactment of the legislation.