

Treasury Report: Draft Cabinet Paper on Policy Issues for KiwiSaver Bill

Date:	27 January 2006	Priority:	High
Security Level:	IN-CONFIDENCE	Report No:	PAD2006/007 T2006/95

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Dr Michael Cullen)	Agree to all recommendations	30 January 2006
Associate Minister of Finance (Hon Phil Goff)	Note	None
Associate Minister of Finance (Hon Trevor Mallard)	Note	None
Minister of Commerce (Hon Lianne Dalziel)	Agree to recommendations b, f to z, and bb	30 January 2006
Associate Minister of Finance (Hon Clayton Cosgrove)	Note	None
Minister of Revenue (Hon Peter Dunne)	Agree to recommendations b, n, aa, and dd to oo	30 January 2006

Contact for Telephone Discussion (if required)

Name	Position	Telephone
	Senior Analyst, Tax Policy, The Treasury	
	Senior Analyst, Financial Sector Team, MED	
Mike Nutsford	Policy Manager, Policy Advice Division, Inland Revenue	

27 January 2006

SH-13-0-7

Treasury Report: Draft Cabinet Paper on Policy Issues for KiwiSaver Bill

Executive Summary

The KiwiSaver Bill is scheduled to be introduced at the end of February 2006. Prior to introduction, final policy decisions are required by Cabinet on all issues that change previous Cabinet decisions or fall outside of the delegated authority for Ministers to make decisions on KiwiSaver. A draft paper for Cabinet Business Committee is attached, based on your previous decisions and the recommendations in this report. The attached paper is subject to final editing, and the Regulatory Impact Statement is a draft and yet to obtain an adequacy statement. A paper for Cabinet Business Committee that includes any revisions will be provided to you on Tuesday 31 January 2006. Although there will not be time to discuss this report with officials prior to submission to Cabinet Business Committee, officials would like to meet with you to discuss issues associated with the introduction of the KiwiSaver Bill.

This report seeks decisions on additional detail around the fee subsidy and several other detailed policy design issues. These decisions are needed to finalise drafting instructions to PCO. Some of these do not require Cabinet approval.

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

Fee subsidy

The main new issue in this report relates to the fee subsidy – in particular, its calculation, administration and monitoring. Officials recommend that the fee subsidy should be a flat dollar amount per member per annum, as this will be easier for savers to understand, government agencies to administer, and providers to attribute to members' accounts.

It would be payable to all schemes, and individuals would pay any additional fees themselves. Officials recommend that the KiwiSaver Bill should allow the detail of the fee subsidy to be prescribed and changed by regulation, to ensure the fee subsidy can be set and modified as appropriate.

Recommended Action

It is recommended that you:

- a **refer** this report to the Minister of Housing;

Referred: Yes/no

Minister of Finance

- b **agree** to meet with officials to discuss issues associated with the introduction of the KiwiSaver Bill;

Agree/disagree.

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Revenue

Minister of Commerce

- c **note** that a draft Cabinet Business Committee paper seeking policy decisions necessary for finalising drafting instructions on the KiwiSaver Bill is attached for your comment;
- d **note** that officials will provide you with a Cabinet Business Committee paper on Tuesday, 31 January, which will allow lodgement on 1 February, and that this paper will be updated, if necessary, to be consistent with any decisions taken in this report;
- e **agree** to defer publication of the Regulatory Impact Statement attached to the Cabinet Business Committee paper until the KiwiSaver Bill is introduced, notwithstanding that publication as soon as possible is required to obtain an adequacy statement;

Agree/disagree.

Minister of Finance

Fee subsidy

- f **agree** that the “fair and reasonable” test for fees be amended so that it requires that fees charged to members should not be “unreasonable”, as this would be simpler to both determine and administer;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Commerce

- g **agree** that the fee subsidy payment will be:

- I. a flat dollar amount payable to each KiwiSaver member per annum;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Commerce

- II.

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Commerce

- III. payable to all providers, both default and active choice;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Commerce

IV. payable to all accounts, including inactive accounts;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Commerce

h

i

j

k **agree** that the following information about the fee subsidy will be made public with the tender documents:

I. that the fee subsidy will be a flat dollar amount per member per annum, applied to the member's account;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Commerce

II. that the amount of the subsidy is unlikely to cover all of the fees of each scheme;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Commerce

III. that individuals would be able to keep any excess of the fee subsidy over actual fee levels;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Commerce

IV. that the fee subsidy would apply to both active and inactive accounts;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Commerce

l **note** that the draft KiwiSaver Bill allows the detail of the fee subsidy to be prescribed and changed by regulation to ensure that the fee subsidy can be set and modified as appropriate;

- m **agree** that MED will be the responsible government agency for the overall administration and ongoing policy advice regarding the fee subsidy;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Commerce

- n **agree** that MED will have the ability to delegate any or all of the administration of the fee subsidy to another Government department, such as the payment function to Inland Revenue, to enable the subsidy to be administered efficiently;

Agree/disagree.

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Revenue

Minister of Commerce

- o **agree** that the fee subsidy should be reviewed by the Minister of Commerce every three years;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Commerce

- p **agree** that trustees would be responsible for ensuring that the subsidy is correctly applied to individuals' accounts, and the Government Actuary would ensure that the trustees have certified that they have correctly undertaken their required function;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Commerce

Detailed design issues

Small balances

- q **agree** that when there has been no contribution received into a person's KiwiSaver account for two or more years providers do not need to report to such members, to reduce administrative costs of holding small and inactive balances;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Commerce

- r **note** that the decision already made to restrict access to a contribution holiday until a member has been contributing for one year is likely to reduce the number of small balance accounts;

- s **agree** that further measures to address any residual small balance issues, such as the options to transfer small balances to a central provider and not allow providers to charge fees in excess of the fee subsidy on balances less than \$1,000, not be included in the KiwiSaver Bill, but note that officials will monitor these issues once the scheme is up and running and amendments could be made in the future to deal with the issue if it becomes significant;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Commerce

Independent trustees

- t **agree** that to protect the interests of members, each KiwiSaver scheme should be required to have an independent trustee as one of its trustees;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Commerce

- u **agree** that the requirement to have an independent trustee should not apply to registered superannuation schemes in existence before 1 April 2007 that convert into a KiwiSaver scheme, because these schemes are not currently obliged to meet this requirement and requiring them to replace their trustee may impose unnecessary compliance costs;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Commerce

- v **agree** that to provide additional protection, the independent trustee of each default KiwiSaver provider should be a statutory trustee company governed by the Trustee Companies Act;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Commerce

Anti-money laundering requirements

- w **agree** that an exemption be given from the initial verification of the identity of clients required by the Financial Transactions Reporting Act for all members allocated to the default product of default providers provided that these providers make reasonable efforts to verify of the identity of the new person;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Commerce

- x **agree** that providers must verify the identity of any person making a voluntary payment in accordance with the Financial Transactions Reporting Act, unless the identity of the person has already been verified;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Commerce

- y **agree** that providers must verify the identity of any person in accordance with the Financial Transactions Reporting Act before any withdrawal or voluntary transfer is processed, unless the identity of the person has already been verified prior to that request;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Commerce

- z **agree** that all KiwiSaver providers have or be prepared to put in place anti-money laundering policies and procedures;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Commerce

Offences

- aa **agree** that the offences and penalties in the parts of the KiwiSaver legislation administered by the Inland Revenue Department be the same as existing tax offences and penalties, in particular the pay as you earn offences in the Tax Administration Act 1994;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Revenue

- bb **agree**, where possible, to align the offences and penalties in the KiwiSaver legislation relating to the regulatory regime with existing Inland Revenue Department offences and penalties in the Tax Administration Act 1994;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Commerce

Application of the Public Finance Act

- cc **note** that you have previously agreed that where an employer fails to on-pay the employee's contribution to Inland Revenue, the full amount will be credited to the employee and a debt would be created with the Commissioner of Inland Revenue to be collected from the employer;

- dd **confirm** that you are comfortable that the decision in recommendation cc implies that employee contributions paid to Inland Revenue are treated as a guarantee arrangement, rather than a trust arrangement, because the Crown is effectively guaranteeing contributions that have been deducted from the employee but not on-paid by the employer;

Yes/no.

Yes/no.

Minister of Finance

Minister of Revenue

- ee **note** that employer contributions and voluntary contributions paid direct to Inland Revenue (e.g. by the self-employed) would not be guaranteed and therefore will be treated as trust money under the Public Finance Act 1989;

Interest earned on funds in the holding account

- ff **agree** that interest paid on employer contributions and voluntary contributions paid direct to Inland Revenue (e.g. by the self-employed) will be paid from the date contributions are received by Inland Revenue, rather than the 15th of the month of deduction (as for employee contributions deducted from wages/salary), because the interest does not relate to payments deducted at source;

*Agree/disagree.**Agree/disagree.***Minister of Finance****Minister of Revenue**

- gg **agree** that interest paid on employer contributions and voluntary contributions paid direct to Inland Revenue (e.g. by the self-employed) will be paid according to the same formula as for employee contributions, and will not be based on the actual rate of interest earned (as required by the Public Finance Act where practicable) due to the difficult and complex nature of applying the actual rate of interest earned;

*Agree/disagree.**Agree/disagree.***Minister of Finance****Minister of Revenue*****Unclaimed money***

- hh **agree** that all unclaimed money held by Inland Revenue (including employee contributions, employer contributions, and voluntary payments) will be treated under the Unclaimed Money Act 1971 for simplicity and because Inland Revenue administers that Act;

*Agree/disagree.**Agree/disagree.***Minister of Finance****Minister of Revenue**

- ii **agree** that the Unclaimed Money Act 1971 be amended so that:

- I. Inland Revenue is included as a “holder” in respect of KiwiSaver contributions;

*Agree/disagree.**Agree/disagree.***Minister of Finance****Minister of Revenue**

- II. KiwiSaver funds are held by Inland Revenue for 6 years before they become unclaimed money, for consistency with the period of time other money is held before it becomes unclaimed under this Act;

*Agree/disagree.**Agree/disagree.***Minister of Finance****Minister of Revenue**

- III. once the member to whom the contribution is attributed has been identified, money is transferred to that member's KiwiSaver scheme rather than refunded directly to the person (unless the person is immediately entitled to draw on those funds);

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Revenue

- jj **agree** that if Inland Revenue wishes to seek an exemption under the Unclaimed Money Act, the request should be made to the Minister responsible for the Act, as specified by the Prime Minister for that purpose (currently the Minister of Revenue), in consultation with the Minister of Finance, to avoid any conflict of interest (because Inland Revenue administers the Unclaimed Money Act);

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Revenue

Financial hardship contribution holiday

- kk **agree** that KiwiSaver members can apply to Inland Revenue for a "financial hardship contribution holiday" for a 3-month period (or such longer period as the Commissioner may determine), at any time after contributions have commenced (after week 11) until 12 months membership (at which time they can apply for a standard contribution holiday), if they meet the same financial hardship criteria used for withdrawals;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Revenue

Privacy issues

- ll **agree** that the Inland Revenue Department may use and share personal information across the department for administering KiwiSaver and its other statutory obligations;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Revenue

- mm **agree** that the Inland Revenue Department may use and share personal information, for example, with the Government Actuary, providers, employers, members and other relevant persons so that it may discharge its duty of administration of KiwiSaver and other statutory obligations;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Revenue

QCIV status of KiwiSaver schemes

- nn **agree** that while default providers will be required to offer qualifying collective investment vehicle (QCIV) funds, these providers should also be able to operate funds that do not have QCIV status in order to provide investor choice and not limit providers to one type of investor;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Revenue

Tax implications of registered superannuation schemes that convert to KiwiSaver

- oo **agree** that the KiwiSaver Bill will clarify the treatment of registered superannuation schemes that convert to KiwiSaver and ensure that the transfer of property as part of a KiwiSaver conversion will not trigger a disposal for income tax purposes;

Agree/disagree.

Agree/disagree.

Minister of Finance

Minister of Revenue

Authorisation

- pp **note** that you will need to seek Cabinet approval to consult with the Minister of Commerce and Minister of Revenue on all detailed design issues, and the Minister of Housing where decisions may impact on home ownership, rather than the Minister of Housing and Minister of Education on all detailed design issues;

Financial implications

- qq **note** that officials consider that any changes in fiscal cost as a result of proposals in the attached Cabinet paper and this report are likely to be small, and able to be managed within the existing Savings Allocation; and

rr **note** that officials will prepare updated costings for KiwiSaver at the time when funds remaining in the Savings Allocation are sought for appropriation (likely at the end of the select committee process), and will report at this time on how any revised estimate of the fiscal cost compares to the level of the Savings Allocation in the HYEPU 2005.

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Hon Dr Michael Cullen
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Minister of Commerce

Hon Peter Dunne
Minister of Revenue

Treasury Report: Draft Cabinet Paper on Policy Issues for KiwiSaver Bill

Purpose of Report

1. This report provides you with a draft paper for Cabinet Business Committee, which seeks agreement for changes to the KiwiSaver scheme. In addition, this report seeks your agreement to additional detail around the fee subsidy and several other detailed policy design issues. These issues do not all require Cabinet approval, but decisions are needed now for final drafting instructions to be provided to the Parliamentary Counsel Office (PCO).

2. We have assumed that a report back to Cabinet is needed on all issues that change previous Cabinet decisions or fall outside of the delegated authority for Ministers to make decisions on KiwiSaver. The attached draft Cabinet Business Committee paper is based on the following previous decisions:
 - modify the automatic enrolment process and the way investment statements for default funds are provided for new employees (covered in report – MED report: Investment Statements and Small Balances);
 - extend the minimum period before a contribution holiday can be taken to twelve months (discussed and agreed at meeting of 15 December 2005);
 - select a limited number of default providers by competitive tender (covered in report KiwiSaver – Issues for Supplementary Drafting Instructions T2005/1974 PAD2005/186);
 - permit other active choice products to be registered, subject to meeting minimum conditions (covered in report KiwiSaver – Issues for Supplementary Drafting Instructions T2005/1974 PAD2005/186);
 - not allow members the option of diverting their contribution to repay their mortgage as part of KiwiSaver (covered in report KiwiSaver – Issues for Supplementary Drafting Instructions T2005/1974 PAD2005/186);
 - enable multiple job holders to contribute from any or all primary and secondary salary and wage sources to encourage scheme participation (covered in report KiwiSaver – Issues for Supplementary Drafting Instructions T2005/1974 PAD2005/186); and
 - cease the fee subsidy when a member becomes eligible to withdraw all of their funds (covered in report KiwiSaver – Issues for Supplementary Drafting Instructions T2005/1974 PAD2005/186).

3. The attached Cabinet Business Committee paper is also based on the following recommendations in this report, and will be revised if necessary to take into account your decisions on these issues:
 - monitoring the government contribution to fees to individual members (paragraph 17.);
 - permitting the Inland Revenue Department to use and share information internally and externally with other persons in order to fulfil its statutory obligations (paragraphs 53. – 55.);
 - ensuring that trustees of schemes are independent (paragraphs 26. – 29.);
 - adapting the anti-money laundering requirements to KiwiSaver (paragraphs 30. – 34.);
 - the tax treatment of KiwiSaver (paragraphs 56. –);
 - unclaimed money (paragraphs 46. – 49.); and
 - implementing an effective offence regime (paragraphs 35. – 40.).

Analysis

Fee subsidy

Fair and unreasonable fees

4. Ministers have agreed that part of the minimum registration criteria for all active choice products would be a requirement to charge fees that are fair and reasonable [T2005/1974, PAD2005/186 refers]. The key purpose of this provision is to prevent providers artificially inflating fees, which is a risk that arises with the provision of a fee subsidy. Officials have been considering how to determine and administer a test for determining what is “fair and reasonable”. There is a general concern that requiring fairness in charging fees could require the court or the Government Actuary to stand in the shoes of the provider and second-guess legitimate commercial decision-making. This is not the intention of the provision, which is targeted at more egregious behaviour on the part of providers in fee-setting.
5. As a result of these concerns, officials recommend the current test be amended so that it requires that fees should not be “unreasonable”. This test creates a higher threshold which should, to some extent, be simpler to both determine and administer and better reflect the intent of the obligation.

Calculation of fee subsidy

6. Cabinet have agreed that the government will negotiate down fees payable to KiwiSaver providers, and pay the remaining ongoing fees [CAB Min (05) 13/9, paragraph 3.14]; and that there will be some cap on the fee subsidy, for example, a cap on the specific dollar amount per person per year, but that how this should be calculated will be determined at a later date [CAB Min (05) 15/2 paragraph 8].
7. There are a number of options around how the fee subsidy could be calculated. For example, providers tend to structure their fees in different ways, and there is scope to consider which fees are considered “ongoing fees” for the purpose of the fee subsidy. Officials have considered two options for the fee subsidy and recommend Ministers agree to option one.

Option 1 – recommended option – A flat dollar payment per person per year (“flat subsidy”)

The same subsidy amount would be paid to members of default and active choice schemes, and would apply to both active and inactive accounts (noting that no member can have more than one account). Individuals in higher-cost schemes would be required to pay any additional fees charged over and above the subsidy amount, although the “not unreasonable” requirement would still apply to all fees, to prevent providers unreasonably raising fees.

Option 2 – not recommended – A percentage of all fees payable up to a fixed dollar amount per person per year (“proportional subsidy”).

The subsidy would be paid to members of default and active choice schemes, and would apply to both active and inactive accounts. Individuals in higher-cost schemes or with higher balances would be required to pay any additional fees charged over and above the subsidy amount, although the “not unreasonable” requirement would still apply to all fees.

8. There are various competing objectives of the fee subsidy. A list of potential objectives, and the advantages and disadvantages of each option in relation to these objectives, is outlined in table 1. In deciding how to structure the fee subsidy, key considerations are whether savers should be subject to ongoing fees, and whether the size of the fee subsidy received by an individual should be related to that individual’s savings balance. There is a trade-off between:
 - reducing complexity and fiscal cost, and reducing the extent to which individuals receive a subsidy for any previous savings (this would be achieved by a flat subsidy); and
 - encouraging individuals to make ongoing contributions by subsidising the fees payable on additional contributions (this would be achieved by a proportional subsidy).

9. Officials prefer adopting option 1 – flat subsidy – for a number of reasons:
 - simpler and lower cost to administer (for providers, the trustees of schemes, and government agencies), which is likely to lead to lower fees;
 - simpler for members and potential members of KiwiSaver to understand;
 - potentially lower fiscal cost over time, as the fee subsidy per person can remain constant (although this effect depends on the fee subsidy cap and whether members can keep any excess of the fee subsidy over actual fee levels);
 - reduces the extent to which small balances are eroded by fees (although perhaps less than option 2 and it depends on the actual level of the subsidy)
 - prevents individuals receiving a subsidy for lump-sum transfers of existing savings balance;
 - more equitable than option 2, as the fee subsidy is unrelated to a members savings balance and income.

10. Officials’ consultation with providers on key policy areas of KiwiSaver suggested that providers also favoured the flat subsidy option (option 1). They are concerned that administration of a proportionate fee would be complex and time-consuming for trustees, potentially imposing upon them significant compliance costs. Any compliance

costs incurred by providers are likely to be passed on to members in the form of fees. An unnecessarily complex fee subsidy structure could, therefore, have the effect of pushing up providers' fees, countering the objective of the fee subsidy.

11. The actual dollar amount of the fee subsidy would be determined after fees have been negotiated with default providers.

12. Providers have suggested that in order to develop a business case for participation in KiwiSaver, they need certainty about the key features of KiwiSaver, and how these features impact on the viability of their participation.

13. Officials consider that some information about the fee subsidy should be made public with the tender documents. This could include (assuming option 1):
 - that the fee subsidy will be a flat dollar contribution per member per annum, applied to the members account;
 - that the amount of the subsidy is unlikely to cover all fees;
 - that individuals would be able to keep any excess of the fee subsidy over actual fee levels; and
 - that the fee subsidy would apply to both active and inactive accounts.

14. Officials consider that the legislation should allow flexibility about how the fee subsidy is set. As experience with the scheme evolves, there may be a need to re-assess the calculation method and level of the fee subsidy. Therefore the draft KiwiSaver Bill allows the detail of the fee subsidy, including the type and amount of the contribution, to be prescribed and changed by regulation to ensure the fee subsidy can be set and modified as appropriate. The Bill is, however, currently drafted with the assumption that a flat fee will be applied. There may be a need for greater monitoring and enforcement if the fee was paid on a proportional basis. If a proportional fee was preferred, officials would need to consider whether the current administration, monitoring and enforcement provisions are sufficient. Officials also consider that the fee subsidy should be reviewed periodically. Therefore the draft KiwiSaver Bill requires

a review by the Minister of Commerce of the fee subsidy calculation or level every three years after implementation.

Table 1: Fee subsidy options

Objectives	Option 1 – flat subsidy (recommended option)	Option 2 – proportional subsidy (not recommended)
Encourage individuals to make ongoing contributions by increasing the net rate of return	No – members would receive the same subsidy regardless of how much they save	Yes – individuals would receive a larger subsidy if they save more
Reduce the likelihood that small balances will be eroded by fees	Yes –	Yes –
Minimise the extent to which individuals can receive a subsidy for lump-sum transfers of pre-existing savings balance	Yes – individuals will receive the same subsidy whether or not they make large transfers into KiwiSaver	Some scope for individuals to receive a subsidy for transfers into KiwiSaver, although this could be limited by the \$ cap
Equity considerations	Individual KiwiSaver members receive the same \$ amount regardless of income	Individuals on higher incomes are likely to receive a higher \$ subsidy, as they are likely to save more in an absolute sense
Simplicity (including minimise administration/compliance costs)	Yes – Reasonably simple for providers, trustees and agencies to administer. Simpler for savers to understand the amount of the fee subsidy	No – more complicated, and may be difficult to administer in practice. May be difficult to communicate
Fiscal cost	Depends on the dollar amount of the subsidy and whether members can keep any excess of the fee subsidy over actual fee levels. May be lower than option 2,	Depends on the dollar amount of the cap and whether members can keep any excess of the fee subsidy over actual fee levels. May be higher than option 1 In addition, the amount of the subsidy per person will generally increase over time as members' balances increase

Objectives	Option 1 – flat subsidy (recommended option)	Option 2 – proportional subsidy (not recommended)
Incentives for providers to minimise fees	Yes – as members are still subject to some fees, and so would benefit from fee reduction.	Depends on the level of the cap and on the proportion of fees covered. If the cap and proportion is low and members are subject to some fees, there will be incentive for providers to minimise fees. If the cap is high and covers all fees for most people, there will be a low incentive for providers to minimise fees
Cost of administration	Likely to be lower as simpler to administer	Complexity of applying the fee subsidy could increase costs to providers, which could be passed on to members in the form of increased fees

Administration and monitoring of fee subsidy

15. Officials consider that the Ministry of Economic Development (MED) should be the government agency responsible for the overall administration and ongoing policy advice regarding the fee subsidy, as it relates to a relationship with providers. This will mean that MED will be responsible for:
 - assessing whether fees are not unreasonable (the Government Actuary);
 - any future review and advice on the amount of the fee subsidy or changes in the calculation of the fee subsidy, in consultation with Treasury and Inland Revenue (although Ministers will determine the level and structure of the subsidy); and
 - the payment and verification of entitlement (note that trustees would be required to verify that the subsidy had been credited to each member's account).
16. Officials consider that MED should have the ability to delegate any or all of the administration of the fee subsidy to enable the subsidy to be administered efficiently. This allows MED to delegate the payment or other functions to Inland Revenue (similar to the current arrangement with the Department of Labour regarding Paid Parental Leave). MED would retain overall responsibility for requirements under the Public Finance Act associated with payment of the fee subsidy.
17. Officials consider that trustees should be responsible for ensuring that the subsidy is correctly applied to individual's accounts. The Government Actuary would ensure that the trustees have certified that they have correctly undertaken their required function.

Detailed design issues

Small balances

18. As previously reported, concerns have been raised by superannuation product providers about the potential for small balances to impact on the commercial viability of operating KiwiSaver schemes [MED report: "KiwiSaver: Investment Statements and Small Balances", 13 December 2005]. This issue arises as a result of the combination of the automatic enrolment provisions and the ability to take contribution holidays, in

particular there may be a significant number of people who are automatically enrolled but who take continuous contribution holidays.

19. At a meeting with officials on 15 December 2005, you supported two provisions that will mitigate the risk of small balances occurring and the impact of small balances on providers:
 - that the contribution holiday can only be accessed once a member has been contributing for 12 months (revised up from 3 months). This will raise the level of members' accounts before they are able to take a contribution holiday; and
 - relief from providers' requirements to report to members when their accounts have been inactive for a period of time. This will reduce the administration costs to providers of holding the account. Officials recommend that this relief should apply where there has been no contribution received into a person's KiwiSaver account for the past two or more years.

20. Ministers agreed that officials should undertake further work to consider the transfer of small balances to a central provider, to deal with any remaining small balances issue. This could enable the provider to gain economies of scale through consolidation of the small balances. Following further work, officials have identified the following risks and costs associated with this option:
 - defining what constitutes a small balances is difficult and likely to vary between providers;
 - the central provider may require further government financial support;
 - many members would have less choice of providers; and
 - members' consent would need to be gained for the transfer of funds, which would be costly and administratively complex, and in some cases very difficult to obtain.

21. Given recent design changes, which may address the small balances issue, and the risks and costs of transferring small balances, we do not recommend any further options to address the issue at this stage. The size and significance of any small balance issue will be clearer once the KiwiSaver scheme is operating. If significant issues do arise in the future, options can be considered at that stage.

22. Officials have previously discussed with Ministers a risk that over time, in situations where a person has continued to take contribution holidays, their KiwiSaver balance could diminish below the government \$1,000 contribution (and potentially to zero), as a result of fees charged by the scheme provider for management or administration of the balance. This may occur, for example, where an individual has withdrawn all but the \$1,000 contribution for the purchase of a first house.

23. Ministers have previously expressed interest in an option to reduce the risk of a members balance reducing below \$1,000 where scheme providers are required not to deduct fees in excess of the fee subsidy from balances under \$1,000. This requirement would not prevent the \$1,000 being eroded through investment losses.

24. There are a number of downsides with this approach, including:
 - penalising people who continue to save, and benefiting those who take ongoing contribution holidays (as providers will need to raise fees elsewhere to recoup this revenue i.e. others will cross subsidise this group);
 - there may be a disincentive for a member to re-start contributions if their balance falls below \$1,000 (which could occur if they withdraw for housing and then experience negative investment returns), as they will become subject to fees on their entire balance;

- members will fully benefit from strong investment returns (for example, they are eligible to withdraw the returns on the government \$1,000 contribution to purchase a first house), but will not bear the full costs of negative investment returns that take their balance below \$1,000;
 - potentially complex for providers to calculate (for example, if a balance is below \$1,000 for part of the year), which may increase administration fees; and
 - may affect providers' willingness to accept non-employees (e.g. the self-employed) who join directly via a provider, as members do not receive the government \$1,000 contribution until membership of 3 months.
25. There may be options to deal with this risk that avoid some of these downsides. However, given that the extent of the problem is unknown and the overall timeline is tight, officials recommend that the issue be considered along with any further consideration of the small balances issues as discussed in paragraph 21.

Independent trustees

26. The KiwiSaver schemes will generally be regulated similarly to registered superannuation schemes to protect members. However, some elements of the superannuation schemes regime may need to be modified to provide additional protection and better suit KiwiSaver.
27. In particular, officials recommend that KiwiSaver schemes should be required to have an independent trustee as one of the trustees for the scheme to protect of the interests of members. An independent trustee would reduce the risk of the trustee facing a conflict of interest between the interests of members and other groups, such as the employer.
28. This requirement should not apply to registered superannuation schemes in existence before 1 April 2007 that convert into a KiwiSaver scheme, which are not currently obliged to meet this requirement. These schemes may have non-KiwiSaver parts so it may impose unnecessary compliance costs if they are required to replace their trustee.
29. In addition, officials recommend that the independent trustee of each default provider should be a trustee company governed by the Trustee Companies Act. Statutory trustee companies are not only independent but are experienced and authorised to act as professional trustees and are required to have sufficient financial backing.

Anti-money laundering requirements

30. The Financial Transactions Reporting Act imposes obligations on financial institutions to verify the identity of its customers and to verify the identities of people where money laundering or proceeds of crime are suspected.
31. An exemption to the Financial Transactions Reporting Act is likely to be needed as it will be impossible to meet the identification requirements for KiwiSaver, especially given the automatic enrolment process where employees become members through inertia.
32. The risk of KiwiSaver being used to launder money is likely to be low given funds are locked in until retirement. Therefore officials recommend that an exemption be given from the initial verification of the identity of clients required by the Financial Transactions Reporting Act for all members allocated to the default product of default providers provided that these providers make reasonable efforts to verify the identity of the new client. Regulations could specify what constitutes reasonable efforts to identify

a new client. This exemption would not apply to members that actively choose a provider by filling in an application form.

33. Money laundering risks remain around voluntary payments, transfers between schemes and withdrawals from KiwiSaver where no identification has previously been provided. Therefore, officials recommend that providers must verify the identity of any person in accordance with the Financial Transactions Reporting Act before any withdrawal or voluntary transfer request is processed, unless the identity of the person has already been verified prior to that request.
34. In addition, officials recommend that KiwiSaver providers either have or be prepared to put in place anti-money laundering policies and procedures.

Offences

35. A range of offences are needed to ensure KiwiSaver works as intended and to provide employers, employees, providers and other people with adequate incentive to fulfil their obligations. Offences are also necessary to provide adequate member and regulatory protection.
36. As part of KiwiSaver will be administered through the pay as you earn (PAYE) tax regime, officials recommend that it is appropriate for the offences and penalties for this part to be the same as existing tax offences and penalties, particularly the PAYE offences in the Tax Administration Act 1994. Hence officials recommend that the parts of the KiwiSaver legislation administered by the Inland Revenue Department be treated as an Inland Revenue Act¹ and the current offences and penalties applying to tax and in particular to PAYE apply to KiwiSaver.
37. The Government Actuary offences need to be consistent with the Inland Revenue offences to ensure consistency of the overall regime but these offences will not be tax offences. These offences are based around the existing offences in the Superannuation Scheme Act 1989. These include offences such as the failure to deliver documents as required by the Act or the failure to carry out a direction made by the Government Actuary. The penalties currently imposed by these offences, however, are significantly outdated. Accordingly, officials recommend that the penalties for the equivalent offences under the KiwiSaver legislation be aligned with the penalties for the tax offences in the KiwiSaver legislation in order to ensure consistency in the proposed legislation.
38. It is not envisaged that agencies would seek to prosecute a person for each and every element of non-compliance but the offences would be used as a tool as appropriate to ensure that persons complied with their obligation under KiwiSaver.
39. The level of the penalties is based on the current penalties imposed under section 143 or section 143A of the Tax Administration Act for absolute liability and knowledge offences respectively². An absolute liability offence is one where failure to do the specified action is sufficient proof that the offence has occurred, so proof of the person's knowledge or intent is not relevant. Whereas for knowledge offences proof of the person's knowledge or intent is relevant. The standard of proof in relation to such

¹ Inland Revenue Act are Acts administered by Inland Revenue, including the Income Taxation Act and Taxation Administration Act.

² The Tax Administration Act 1994 offences are punishable on conviction to a fine not exceeding \$12 000 for absolute liability offences and a fine not exceeding \$50 000 and/or a term of imprisonment of up to five years for knowledge offences.

proceedings relating to these offences is beyond reasonable doubt and the onus of proof rests with the Commissioner or Government Actuary.

40. A person will not be convicted of an offence:
- of not providing information (other tax returns, income statements and tax forms) if the person proves that the person did not have the information in his or her knowledge, possession or control; and
 - for knowingly applying or permitting to be applied a KiwiSaver contribution for another purpose if the deduction has been accounted for and the failure to account for it on time was because of an illness, accident or other cause beyond the taxpayer's control.

Funds in the Inland Revenue holding account

Application of the Public Finance Act

41. You have previously agreed that where an employer deducts a KiwiSaver contribution from an employees' pay but does not send all or some of the amount to Inland Revenue, the employee will be credited with this amount. The amount would be passed to the employee's provider, and a debt would be created with the Commissioner of Inland Revenue and collected from the employer [T2005/268, PAD2005/39 refers].
42. This effectively creates a government guarantee, and means that employee contributions will be subject to a guarantee arrangement, rather than a trust arrangement. Therefore these funds will not fall under the trust account provisions in Part 7 of the Public Finance Act. In contrast, employer contributions and voluntary contributions made by non-employees (such as the self-employed) via Inland Revenue are not guaranteed by the Crown and will be subject to the trust account provisions in Part 7 of the Public Finance Act.
43. Officials want to confirm that you are comfortable with employee contributions paid to Inland Revenue being treated as a guarantee arrangement.

Interest earned on funds in the holding account

44. You have previously agreed that for the purposes of calculating interest, contributions will be treated as having been received by Inland Revenue on the 15th of the month of deduction, rather than on receipt. This makes sense for employee contributions, because the contribution will be deducted from a person's salary or wages and held by the employer for up to 51 days before Inland Revenue receives and is able to pass the contribution on to the provider. However, employer contributions and voluntary contributions are paid direct to Inland Revenue, and not via a third party. Therefore officials recommend that interest paid on employer contributions and voluntary contributions should be paid from the date contributions are received by Inland Revenue.
45. In respect of trust monies, the Public Finance Act requires interest on these contributions to be the actual interest earned where practicable. However, officials consider that paying the actual rate of interest earned on these contributions would be difficult and complex, particularly given the time available before implementation. Therefore, officials recommend that interest on employer contributions and voluntary contributions is paid according to the same formula used for employee contributions.

Unclaimed money

46. It is likely that Inland Revenue will receive KiwiSaver deductions that it is unable to attribute to a person. For example, the Inland Revenue number provided may be invalid or a person may give a fictitious name. This money will not be able to be processed and forwarded to a member's fund. Inland Revenue will endeavour to identify the person so that the money can be provided to a member's fund or default fund (or employer's default). To be consistent with existing decisions, officials consider interest should not be paid until the member is identified and only upon the transfer of funds.
47. In instances, where the employee cannot be identified (for example, where the employee has ceased working for the employer), the funds would become unclaimed money. Generally, unclaimed money that is held by the private sector falls under the Unclaimed Money Act 1971, whereas unclaimed money that is held by the public sector falls under the Public Finance Act 1989. However, unclaimed KiwiSaver contributions would likely require amendments to either Act to be dealt with appropriately, mainly to take account of the lock-in of KiwiSaver contributions. Officials recommend that KiwiSaver contributions be treated as falling under the Unclaimed Money Act, rather than the Public Finance Act. Inland Revenue already administers the Unclaimed Money Act. Treating unclaimed KiwiSaver contributions under the Unclaimed Money Act would allow use of existing systems and processes already in place by Inland Revenue. There would also be synergies with this function and Inland Revenue's role as central administrator of KiwiSaver funds.
48. Officials recommend that KiwiSaver contributions become unclaimed money under the Unclaimed Money Act if Inland Revenue cannot identify the person within 6 years, for consistency with the period of time other money is held before it becomes unclaimed under this Act. Once the member to whom the contribution is attributed has been identified, officials consider such money should be transferred to the member's KiwiSaver scheme rather than refunded directly to the person unless that person is immediately entitled to draw on those funds.
49. Amendments will be required to the Unclaimed Money Act to include Inland Revenue as a "holder" in relation to KiwiSaver contributions under that Act. A potential conflict of interest arises because under the Unclaimed Money Act, a "holder" can apply to the Commissioner of Inland Revenue for an exemption from certain requirements in the Act. It is envisaged that Inland Revenue will need to apply for exemptions under the Unclaimed Money Act, for example, if Inland Revenue cannot identify the owner of the money and therefore cannot send a notification to that owner, as required by the Act. Officials recommend that to avoid any conflict of interest, Inland Revenue should be required to seek any exemption from the Minister responsible for the Unclaimed Money Act and specified by the Prime Minister for that purpose (currently the Minister of Revenue), in consultation with the Minister of Finance.

Financial hardship

50. Cabinet has agreed that members will be able to withdraw their funds from KiwiSaver in cases of financial hardship [CAB Min (05) 13/9 paragraph 3.8]. It is envisaged that this will apply both to funds held by providers, and funds held by Inland Revenue during the holding period, and that the same definition of financial hardship will be used for both.
51. Ministers have agreed that members will be able to apply for a contribution holiday, after 12 months, enabling them to cease contributions for up to five years at a time. However, there is currently no mechanism to allow contributions to cease during the

initial 12 months in cases of financial hardship (even though members are able to access their funds if they meet the financial hardship criteria).

52. Officials recommend that members should be able to apply to Inland Revenue for a short “financial hardship contribution holiday”, for three months duration or such longer period as the Commissioner of Inland Revenue considers appropriate given the nature of the financial hardship, at any time after contributions have commenced (i.e. after week 11). Individuals would need to meet the same financial hardship criteria as used for financial hardship withdrawals. The financial hardship contribution holiday for 3-months would be able to be rolled over if the financial hardship continues. After 12 months, members will be able to apply for a standard contribution holiday.

Privacy issues

53. The administration of KiwiSaver will involve the collection and use of personal information as the Inland Revenue Department will need to maintain information about contributions deducted and on-paid, and about providers receiving contributions. The Inland Revenue Department will need to use and share personal information with, for example, the Government Actuary, providers, employers and members. These roles may breach the current privacy law which prevents information collected for one purpose being used for another distinct purpose.
54. Officials recommend that the Inland Revenue Department be authorised to use and share personal information across the department and, for example, with the Government Actuary, providers, employers, members and other relevant persons so that it may discharge its duty of administration of KiwiSaver and other statutory obligations. An amendment to the Inland Revenue Department’s secrecy provisions and other statutory authority will be needed to permit this information use and sharing.
55. Officials will complete a detailed privacy assessment for KiwiSaver and the views of the Privacy Commissioner will be sought.

QCIV status of KiwiSaver schemes

56. It is important that if employees are encouraged to save through KiwiSaver, that the earnings from such investments are taxed consistently and fairly. The proposed tax rules for qualifying collective investment vehicles (QCIVs) are designed to achieve this.
57. From 1 April 2007, it is proposed that a pooled fund that qualifies as a QCIV would be able to elect a new set of tax rules. Assessable income would generally exclude realised domestic share gains and be “flowed through” to investors, with the QCIV deducting tax at investors’ elected tax rates. Officials are still to report on the final details of this proposal and it is expected to be included in a tax bill to be introduced in May this year.
58. In general, officials consider that the QCIV election decision should be left up to individual trustees. For default schemes, however, officials consider that the Government should make the QCIV election decision. This is because unless mandated, trustees focussing on the needs of the majority investor may not meet the needs of those on low incomes. Consistent with this, you have previously agreed that KiwiSaver default providers be required to become QCIVs to ensure low income earners are not over taxed but that active choice providers can decide their QCIV status [T2005/2366].
59. As a result of further consideration, officials consider that the requirement for a default provider to become a QCIV should not prevent the provider from offering both QCIV

and non-QCIV products for KiwiSaver purposes. Default providers should be able to operate funds which do not have QCIV status in order to provide investor choice and not limit providers to one type of investor.

Tax implications of registered superannuation schemes that convert to KiwiSaver

60. Cabinet has agreed that the Government will provide a conversion mechanism for existing registered superannuation schemes (RSS) that want to migrate to KiwiSaver [CAB Min (05) 13/9 paragraph 3.21]. Under the Income Tax Act 2004, this could be considered a disposal of property, therefore resulting in taxable income.
61. For certainty it is recommended that the KiwiSaver legislation clarify the treatment of RSS schemes that convert to KiwiSaver and ensure that the transfer of property as part of a KiwiSaver conversion will not trigger a disposal for income tax purposes.

Authorisation

62. Cabinet authorised the Minister of Finance, in consultation with the Minister of Housing and Minister of Education, to agree outstanding detailed design issues for KiwiSaver [CAB Min (05) 13/9 paragraph 7]. However, any additional detailed design issues are likely to be related to the regulatory environment, the role of employers, and administration issues. Therefore officials recommend that you seek Cabinet approval to instead consult with the Minister of Commerce and Minister of Revenue on all detailed design issues, and the Minister of Housing where decisions may impact on home ownership.

Financial implications

63. The estimated fiscal cost of KiwiSaver has been set aside in the Savings Allocation, which was included in the Half-Year Economic and Fiscal Update (HYEFU) 2005. The Savings Allocation in the HYEFU updated the Savings Allocation from Budget 2005 [POL Min (05) 9/1 (4)] for forecast changes [T2005/2075 refers].
64. Overall, officials consider that any changes in fiscal cost as a result of proposals in the attached Cabinet paper and this report are likely to be small, and able to be managed within the existing Savings Allocation. Changes that could have some fiscal impact include:
 - extending the minimum period before a contribution holiday can be taken may reduce participation in KiwiSaver, and therefore fiscal cost, although the effect is very uncertain and unlikely to be significant; and
 - the proposal to change the automatic enrolment process of new employees may increase pressure on administration costs for IRD, but this is unlikely to be significant.
65. As there may be further changes to KiwiSaver, such as any changes to the KiwiSaver Bill arising from the Select Committee process, officials recommend that final costings for KiwiSaver should be prepared at the time funds remaining in the allocation are sought for appropriation (likely at the end of the select committee process). Officials will report at that time on how any revised estimate of the fiscal cost compares to the level of the Savings Allocation in the HYEFU 2005.

Further report backs

66. Officials propose to provide you with a revised version of the explanatory notes and draft KiwiSaver Bill in early February. Officials will also prepare a paper for Cabinet Legislation Committee, which will be provided shortly thereafter.

67. Further reports are also likely on:
- the NZX proposal (mid to late February); and
 - further details around the tender process for default providers (late February).