

“Extreme” salary sacrifice

“**Extreme** 1. n. (of a quality condition or feeling) existing in a very high degree; very great or intense; (of a action measure etc.) very severe or violent;”

Shorter Oxford English Dictionary

The Inland Revenue on 1 February 2006 released an “officials’ issues paper” called **Countering extreme salary sacrifice** – Ensuring that employer superannuation contributions are taxed fairly.

This newsletter looks at the paper and the “problem” and discusses some of the implications. Until the

Government decides what it will do in response to the issues paper, and prepares legislation, it is not possible to advise what response employers should make. The Inland Revenue intends to implement the changes on 1 April 2007.

You can see the full paper at www.taxpolicy.ird.govt.nz. The paper is not complex or “heavy”. It is just 9 pages of text.

What the paper says

The issues paper says that the Inland Revenue wants to “improve the SSCWT rules”. It describes the problems as:

- **Electing tax rates** - because of the way that the 2003 variable SSCWT rates work, employees can effectively choose the tax rate that applies to their total income (pay + superannuation contributions).
- **Complex rules** - the Inland Revenue says the “rules for calculating SSCWT have become more complex over time” and need “simplifying”.

It proposes a solution of:

- **Aggregating remuneration** - All members’ direct pay and contributions paid to the employer’s scheme for the period will be aggregated.
- **Changing SSCWT scale** - SSCWT will then apply with the rate being the one appropriate to the total remuneration, not just the cash pay.
- **Increasing the thresholds** - each of the SSCWT thresholds will be increased by 15% so

that genuine employer contributions that take remuneration to just over a threshold will not result in “over-taxation”. So, for example, if the total remuneration is more than \$43,700 a year (\$38,000 increased by 15%), the top 33% rate will apply to all employer superannuation contributions, regardless of the employee’s marginal tax rate on direct pay.

- **Removing two options** – two options currently offered for the taxation of employer contributions (a flat 39% rate and a PAYE option) will be removed. Perhaps that is because no-one uses them.

There are no changes proposed to the Fund Withdrawal Tax (FWT) regime. Likewise there is no change to the distinction between the top rate of personal tax (39%) and the top SSCWT rate (33%).

For most employers, the changes will not result in higher SSCWT liabilities or reduced net employer contributions for employees. The changes will however, result in greater compliance calculations and probably payroll system changes, unless the employer adopts the single 33% regime.

The Inland Revenue seeks “views on the suggested changes (by 15 March 2006) before [it] makes final recommendations to the government”. The address for comment is Policy.webmaster@ird.govt.nz.

The Inland Revenue describes the problem as:

“In some cases, people earning comparatively high levels of income can reduce their tax so that they are paying significantly less than other taxpayers who earn the same or less income.”

The release of the paper is not a surprise. In our “Reflections on 2005”, we said that we expected changes in this area in 2006. The issue has arisen because of the artificial distinction between the tax treatment of employer superannuation contributions and direct pay. This was introduced in 2000 and then exacerbated in 2003 (refer background on page 2).

In introducing the original PAYE tax changes in 2000, the government acknowledged that *“the aim was that genuine superannuation savers, even if they are high income earners, will be taxed at 33 cents. This incentive may persuade people to increase their savings, with some loss of potential tax revenue to the Government, but we are not averse to this.”*

The government did not expect that individual employees would use the 2003 changes to the system to reduce their tax rate below 33%. The paper refers to this as “extreme salary sacrifice”.

There is no information in the paper on the scale of the problem of “extreme salary sacrifice”. In separate comments, Inland Revenue officials said that tax payments under the “specified superannuation contribution withholding tax” (SSCWT) regime grew by 32% from 2004 to 2005 (from \$502 million in 2004 to \$662 million in 2005).

However, the officials do not know how much of this is due to “extreme salary sacrifice”. As they said themselves, the increase could be due to “other factors such as people genuinely saving more money”. This is a curious concession and is probably right. Something like \$15 million of the increase could be explained by the expansion of the government’s own State Sector Retirement Saving Scheme.

While we suspect that most of the increase is genuine savings, it doesn’t change the fact that it is open to potential abuse. We would however have liked to see more evidence of this.

Issues and comments

Our main concern with the proposal is that it is more change. Like all change, there will be compliance costs. In response, we suspect that many employers will go back to the standard 33% SSCWT rate for all employees.

We are also concerned that the issues paper proposes a single solution and does not discuss the alternatives. One practical option not considered is a return to the former pre 2003 regime of a standard 33% SSCWT rate as the sole effective option.

Other issues include:

- most employers struggle to cope with more than one definition of “pay”; now there could be a third definition if the employer maintains the variable rate option.
- there is no comment on design issues like unvested benefits, unallocated defined contribution schemes or defined benefit schemes.
- many members have more than one employer.
- the behaviour signals that the new regime sends to employees. This may result in more salary sacrifice, but less “extreme salary sacrifice”.
- the life cycle objectives of individuals and the fact that the new system penalises those who save late in life as opposed to those consistently saving.
- the costs of compliance and payroll system changes.
- whether pay is last year’s pay (as at present) or current year’s.
- the impact of pay increases during a tax year and the payment of bonuses.

Background

Until 1 April 2000, the rate of tax payable on employer contributions (SSCWT) equalled the top personal marginal income tax rate of 33%. The 33% SSCWT applied to all employer contributions including for those who earned less than \$38,000 and who had a marginal PAYE rate of 15% or 21%.

On 1 April 2000, the top marginal PAYE income tax rate was raised to 39% but the SSCWT rate was left unchanged at 33%. Employees could then sacrifice salary, otherwise taxed at 39%, to be taxed as 33% as an employer contribution.

To avoid the potential for abuse i.e. employees sacrificing salary, saving the 6% tax and then immediately withdrawing the net amount as a benefit, the government imposed a 5% fund withdrawal tax (FWT) on 1 October 2000. This still allowed tax planning and to some extent legitimised it, but limited the benefit unless it was for long-term savings.

Since its introduction in 1989, some sectors of the industry argued that SSCWT at 33% for

all disadvantaged lower income earners. On the surface, the industry appeared correct - employees earning below \$38,000 had a marginal PAYE rate of less than 33%. However, very few employees earning below \$38,000 (including overtime etc) saved via superannuation and for most in this category, because of income support family assistance etc, their effective marginal tax rate was well above 33% i.e. they were better off to take more employer superannuation taxed at 33% and not more income. There was never any evidence that lower paid employees left schemes because of this “disadvantage”.

Despite there being a difference between perception and reality, the government introduced the variable SSCWT rate from 1 April 2004 (see www.SuperLife.co.nz/articles for more information on SSCWT).

A consequential effect of the variable rate of SSCWT was that an employee could sacrifice income to reduce the marginal PAYE rate to 21% (or in some cases 15%). This had the effect of reducing the SSCWT rate to 21% (or 15%).

The purpose of the “Officials’ Issues Paper” is to remove the potential for abuse by limiting the ability of higher income earners to reduce their SSCWT rate below 33%.