

Salary sacrifice

- a discussion paper

Salary sacrifice has become an issue in New Zealand since the introduction of individual marginal tax rates (i.e. 39%) above the tax rate applicable on employer contributions to superannuation schemes. It has become a legitimate practice since “fund withdrawal tax” applied to superannuation schemes from 1 April 2000.

What is salary sacrifice?

Salary sacrifice is where employees package (i.e. swap) part of their cash pay, to receive remuneration in another form more suited to their needs, such as higher employer contributions to a superannuation scheme. The total value of their gross remuneration, and cost to the employer, remains unchanged, though depending on their income level (e.g. if they earn over \$60,000) their net remuneration will increase.

An example will explain (see table 1).

What are the benefits of allowing salary sacrifice?

For individuals who earn above \$60,000, salary sacrifice results in higher net-of-tax remuneration, and allows them to save for their retirement out of income that is effectively taxed at a lower rate (i.e. 33% and not 39%). For every \$10,000 sacrificed and saved, the overall tax level is reduced by \$600.

For an individual earning more than \$60,000 of total cash income (i.e. salary and investment income), it also means that the investment income earned on the sacrificed salary is taxed at only 33% and not 39%. This difference is perhaps more significant over time than the initial tax saving on the contributions.

For individuals earning less than \$60,000, a benefit will also arise if it lowers the tax rate applicable on employer contributions below 33%.

From an employer’s perspective, encouraging salary

sacrifice results in employees building a higher level of wealth for their retirement, and having greater individual accountability for their retirement savings and financial health. Both of these factors must benefit an employer in managing its employees.

By sacrificing salary and receiving a higher employer contribution, an employee receives lower immediate income and higher deferred income. One issue that arises therefore is, should an employer allow the employee to access his/her sacrificed salary from the superannuation scheme while still in service?

Should employers allow “access” to the sacrificed salary paid as superannuation contributions while the employee remains in service?

Allowing access is a philosophical issue. From the employer’s viewpoint, it does not result in any extra costs. It might result in the employee paying tax on the accessed benefit. However any tax payable is deducted from the individual’s benefit and is therefore at their cost and not the employer’s.

Most employees will not want to withdraw money, as they will want to save it in the scheme (provided the scheme has a high level of flexibility). However,

Table 1

	Current remuneration \$	Packaged remuneration \$
Gross position		
Cash pay	100,000	60,000
Superannuation contribution	<u>7,500</u>	<u>47,500</u>
Total gross remuneration	107,500	107,500
Net-of-tax position		
Cash pay	69,730	45,330
Superannuation contribution	<u>5,025</u>	<u>31,825</u>
Total net remuneration	74,755	77,155
Difference		2,400

knowing that they can access the sacrificed salary, if they need to, will provide a level of comfort and security.

Does the 5% superannuation scheme fund withdrawal tax (SSFWT) apply?

In some cases yes. In most cases no. Where it does apply, it will mainly be because salary is sacrificed and withdrawn while in service. It cannot apply unless money is withdrawn. Attached is a paper that explains this SSFWT tax in more detail.

Even if SSFWT does apply, individuals still benefit through overall lower tax (see table 2 below).

If sacrificed salary is withdrawn, do individuals still gain a benefit?

Yes, from an individual’s perspective, even if the contribution is withdrawn and taxed there is still a net benefit. The net benefit arises as the 5% withdrawal tax applies to the net contribution and the 6% saving (i.e. 39% – 33%) applies to the gross pay. The example in Table 2 explains this.

What will other employers do?

We expect that there will be a continual shift to salary sacrifice and therefore most employers will need to consider their options so that they remain

competitive. Overall it is a win-win remuneration practice and we expect the majority of employers to adopt the concept of salary sacrifice to some degree.

What should employers consider?

As a minimum, we believe that employers should consider allowing employees earning above \$38,000 to package any current member contribution they make to a current plan, as an employer contribution. This is particularly efficient for employees earning above \$60,000 as above this level the 39% marginal tax rate applies. However between \$38,000 and \$60,000 there are still advantages because of the “2-year/150%” rule under the SSFWT regime and because of ACC.

We also believe the employer should consider allowing employees to have future bonuses channelled through a superannuation scheme as employer contributions.

Long-term, to remain competitive, we think that employers will need to consider allowing employees to sacrifice pay increases and even current pay. The presence of the SSFWT regime makes such practices legitimate. It might lower tax but it is not tax evasion. For employees who want to save for their retirement this probably remains the best option as saving out of after-tax

income is not as efficient.

Allowing “access” while the employee is still in service is a harder issue. Here, there are opportunities for abuse and caution is demanded. We think that employers should allow access in cases of hardship or an employee’s change in circumstances (such as divorce/separation). Employers should also recognise that there are good reasons to allow total access. The only negative is compliance costs in terms of administration, but we believe that these need not be significant if managed well.

If an employer has an existing scheme, it should consider providing for salary sacrifice, except for current employee contributions, via a separate arrangement e.g. a master trust. This will also simplify administration and address the investment issues referred to below.

What issues arise?

There are two key issues to be considered. The investment of the sacrificed contributions and the impact on ACC and other benefits. Employers will also need to consider the current provisions of their trust deeds and the optimal vehicle.

Investment issues

Employees who sacrifice salary for retirement savings purposes will generally have above average wealth and will want the investment of these assets to be part of their overall investment strategy. Many will want a higher level of share investments, particularly overseas shares on their sacrificed pay, than an employer superannuation scheme typically allows. They will also want them to be invested tax

Table 2

	Position in respect of \$40,000 “sacrificed salary” under different scenarios		
	If taken as salary \$	If sacrificed and subject to SSFWT \$	If sacrificed and no SSFWT \$
Income	40,000	40,000	40,000
PAYE/SSCWT	<u>15,600</u>	<u>13,200</u>	<u>13,200</u>
Net income	24,400	26,800	26,800
SSFWT	-	<u>1,340</u>	<u>0</u>
Net income	24,400	25,460	26,800
Gain	-	1,060	2,400

efficiently and may also want portability.

Employees looking to access their sacrificed salary will want a greater focus on certainty and cash assets.

For each of the above reasons, salary sacrifice will increase the demand for investment choice in existing schemes. This will be a good reason to consider a “master trust” option as the vehicle for the scheme overall, or at least for the sacrificed contributions. An article explaining the master trust options in New Zealand is available as required. Master trust information is also available on www.mastertrusts.co.nz.

ACC

Currently in NZ, ACC income benefits are based on salary up to \$94,226. Where employees sacrifice salary to reduce it below this level, they save on their own ACC levy (likewise so does the employer) but will also reduce their potential ACC income-related benefit payable. Some employees may not wish to sacrifice below this level for this reason. We suggest that any employee who does, should separately evaluate their disability income needs and that employers should warn employees of the consequences.

Current trust deed provisions

In order for an existing scheme to be used, the trust deed will need:

- flexibility in the definition of “salary”
- flexibility in terms of access
- appropriate contribution provisions that allow for variable employer contributions

- appropriate investment arrangements
- flexibility in terms of vesting. Sacrificed contributions will need to be fully vested.

Trustees will also need to ensure that their life and disablement insurance policy can cope with the sacrificed salary and for the insurance formula to be based on notional (i.e. equivalent gross remuneration) salary.

Payroll system

A key administration issue relates to the payroll system. Can it handle multiple definitions of salary, variable employer contribution rates and multiple SSCWT rates?

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