Consultative Document on Superannuation and Life Insurance

Volume 1

MARCH 1988

CONSULTATIVE DOCUMENT
ON
SUPERANNUATION
AND
LIFE INSURANCE

Volume 1

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PREFACE

Introduction

In the Government's Economic Statement of 17 December 1987, I announced that the tax treatment of superannuation and life insurance would be moved onto the same basis as other forms of savings and investment. This consultative document discusses the reasons behind that decision and presents detailed proposals for the implementation of a non-concessionary regime.

The Tax Reform Programme

The present reform exercise represents the final stage in a process that began in 1982 with the partial removal of tax concessions for lump sum superannuation schemes. Further changes, announced in my first Budget in 1984, moved the tax treatment of life insurance and superannuation closer to the desired neutral regime. At the same time I announced that all aspects of the taxation of life insurance, superannuation and related areas would be reviewed. Since then other major tax reform projects have taken precedence, including the introduction of GST, the associated changes to the income tax scale, Family Support, and a number of significant reforms relating to the tax treatment of capital income.

Changes to the tax treatment of capital income have been aimed at achieving a consistent treatment of income from investment, irrespective of the form that investment takes and the institution through which it is made. In this way, the potential for the tax system to influence investment decisions and thus distort the allocation of resources within the economy can be minimised. The application of a consistent tax treatment for income from alternative types of investment also puts an end to a variety of tax avoidance practices which have been used for the benefit of a few at the expense of the community as a whole.

Recently attention has been focussed on the introduction of a full imputation system for the taxation of company income and the reform of the tax treatment of income earned offshore. These measures are currently under review by the Consultative Committee on International Taxation and Full Imputation.

Superannuation and Life Insurance

Under the system applying before 17 December 1987, the tax treatment of savings made through superannuation (and, to a lesser extent, life insurance) was highly concessionary. These concessions provided benefits to those covered by such schemes at the expense of other taxpayers. Since such coverage is more common amongst those on higher incomes, the benefits from the concessions have not been distributed fairly. Furthermore, the concessions have distorted people's savings and investment decisions as well as impacting on employment contracts and creating numerous avenues for tax planning.

The Government has of course considered the arguments in favour of concessions for these forms of saving but found them unconvincing. Our reasons for rejecting these arguments are discussed in the document.

At an estimated revenue cost of $660 million in 1988/89, the tax concessions for superannuation and life insurance have been very expensive. It is important to appreciate that without their removal it would not have been possible to provide the further cuts in the company and personal rates of income tax that were announced on 10 February 1988.

Transition to a Non-Concessionary Regime

As can readily be seen from the present tax regime applying to superannuation, reform in the area of superannuation is inevitably complex. This complexity arises from the long-term nature of the contractual obligations involved, and the need to

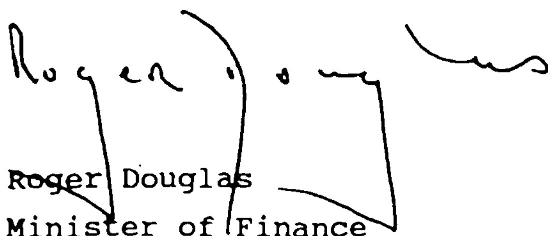
protect individuals who would be unduly disadvantaged by the immediate removal of concessions. Previous reforms have employed the "grandfathering" approach whereby those who had joined schemes or taken-out policies prior to the announcement of reforms were able to continue to benefit from concessions - in some cases, for very long periods. Piecemeal reforms, coupled with this approach to transition, have produced the present intractable system of categories of superannuation, each with its own peculiar tax regime.

The objectives of the transition process considered in this document will be to protect the position of those in or near retirement, minimise disruption to the industry and the economy and, if possible, produce a regime that is less complex than the present one.

The Consultative Process

A committee has been formed to consider the detailed proposals set out in this document and receive submissions on the proposals from interested groups and individuals. The Committee will also be asked to prepare draft legislation to give effect to their recommendations.

The Government invites public consideration of this document and welcomes suggestions on ways to improve the implementation of and transition to a neutral tax regime for life insurance and superannuation.



Roger Douglas
Minister of Finance

CONSULTATIVE DOCUMENT ON SUPERANNUATION AND LIFE INSURANCE - Volume 1

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CHAPTER 1 - INTRODUCTION

1.1. The Importance of Superannuation and Life Insurance

Superannuation funds and life offices have played an important role as vehicles through which people have accumulated savings. The extent to which people have saved through life insurance is indicated by the fact that life offices have almost three million policies in existence with respect to their New Zealand business and have assets of over $10 billion. Non-superannuation premiums for the year ending with the September quarter 1987 totalled some $620 million. A survey commissioned by the Life Offices Association in February 1985 and conducted by the Heylen Research Centre estimated that approximately half the New Zealand population over the age of fifteen years have some form of life insurance cover. Superannuation membership is also extensive. Over 700,000 people belong to superannuation schemes which hold total funds amounting to some $11.5 billion with annual contributions of over $1.4 billion.

Superannuation funds and life offices are therefore repositories of a very significant level of savings for large numbers of people. It is thus important that these institutions, and those who save through them, be taxed in a manner which is both fair and economically efficient.

1.2 Announced Policy Changes

In the Economic Statement of 17 December 1987 the Minister of Finance announced major changes to the taxation of superannuation and life insurance. The announced changes were detailed in Annex 3 of the Statement. Further details were announced in the 10 February press statement of the Minister of Finance. Those statements are reproduced in Appendix A1.1 of this Document.

In essence, the announced changes involve:

- removal of the previous tax exemption for member superannuation contributions and life insurance premia;

- removal of the fringe benefit tax exemption for employer superannuation contributions and employer-paid life insurance premia;

- removal of the tax exemption previously enjoyed by most superannuation funds; and

- removal of the tax impost on superannuation pension benefits.

1.3 Overview of the Reasons for Reform

Since taking office the Government has embarked on a major programme of taxation reform. The overall aim has been to raise taxation revenue in a way which is more efficient (in that it imposes the lowest possible economic costs on the community), fairer (with the tax burden being distributed equitably across different sectors of the community) and simpler than the tax system inherited in July 1984.

Broadly, the means of achieving those objectives are to broaden the tax base by, for instance, removing income tax concessions and introducing GST, and by making tax rates lower and less variable. The business taxation measures announced on 17 December 1987 have advanced this process considerably. Central to those measures was a more consistent tax treatment of capital income, that is income from savings and investments of various kinds.

In the past saving and investment income has been treated differently according to the type of saving or investment made and the institutional form through which that investment or

saving was channelled. That distorted the pattern of savings and investment, resulted in some taxpayers being favourably treated relative to other taxpayers, and added to the complexity of the income tax system. Reforms over the past few years (such as the accruals regime for debt instruments, the primary sector taxation reforms, and the phased removal of accelerated depreciation allowances) have gone a long way to reducing tax imposed distortions in saving and investment patterns.

Considerable anomalies, however, remained. Savings and investments chanelled through companies were, in general, taxed penally. The so-called classical corporate tax system taxed company income twice: once when it was derived by the company and secondly when it was distributed to shareholders as dividends. That penal treatment will be removed by the implementation of the imputation system outlined in the December 1987 Consultative Document on Full Imputation. The primary stated objective of the imputation system is to ensure that, as far as possible, income earned through a company, is taxed at the marginal rates of the shareholders in the company.

While savings and investments chanelled through companies were in general penally taxed, those chanelled through offshore companies and similar entities could receive significant tax advantages since the income accumulating offshore could remain free of New Zealand tax, at least until distributed back to New Zealand resident individuals. That anomaly, and policies to deal with it, are outlined in the December 1987 Consultative Document on International Tax Reform. A stated objective of those measures is thus to reduce the extent to which the tax system encourages offshore investment relative to investment in New Zealand and biases the form in which offshore investment is made.

A third major distortion in the taxation of savings and investment income has been the tax exemption for certain increases in wealth which fall within the category of capital rather than income gains. It was announced in the 17 December

Economic Statement that the Government intended to examine intensively the scope for the introduction of capital gains and/or asset taxes.

Savings channelled through superannuation schemes have also received concessionary tax treatment vis a vis savings and investments through other intermediaries. In particular, for many superannuation schemes investment income (the equivalent of interest income on the savings) was not subject to taxation as it was derived by the superannuation fund. To implement the Government's overall objective of removing differences in the tax treatment of different forms of savings and investment income it was obviously necessary to remove that exemption.

As noted above, life insurance is an additional instrument through which considerable savings are channelled. Life insurance has a tax regime which is peculiar to that form of saving. A review of the taxation of life insurance is therefore appropriate at a time when the rules on the taxation of capital income in general are being brought more closely into line.

There is a connection between superannuation and life insurance. Partly this is historical. Because of their experience as investment managers, a large proportion of superannuation is conducted through or mangaged by life offices. In part the connection is related to the fact that both life insurance and superannuation can be savings instruments with a return which, to some extent, is dependent on mortality and/or other human contingencies.

This connection between life insurance and superannuation is not by itself a reason for including them both within the ambit of the same review process. However, since life insurance needs to be considered as part of the overall measures aligning the taxation of capital income, the connections between these two forms of saving and investment means that they can be conveniently considered together.

The important point to note is that the announced changes to the tax treatment of superannuation and life insurance constitute an integral part of the business taxation reforms announced on 17 December 1987 which has as one of its objectives the consistent tax treatment of income derived from savings and investment. The measures in this area should not be seen in isolation from the announced international tax reforms and corporate imputation. Moreover, the international reforms and the superannuation and life insurance reforms are both measures which reduce taxation concessions and thus should result in an increase in taxation revenue.

That increase in revenue is able to be used to assist in offsetting the reduction in revenue which should result from imputation and to assist in paying for the major reductions in personal and corporate taxation rates which were announced on 10 February 1988. In turn those reduced tax rates make the international tax measures and the changes to superannuation and life insurance more feasible. The inter-dependency between the various measures announced by the Government needs to be recognised.

1.4 Objectives of the Superannuation and Life Insurance Taxation Reforms

The objectives of the reforms in this area are:

a to ensure that, as far as possible, income derived from savings in a superannuation fund or life office are taxed at the marginal rates of the scheme members and policyholders;

b to seek to tax the income of the life office itself on the same basis as income derived by other companies;

c to minimise the disruption the new regime imposes on superannuation funds, scheme members, life offices and policyholders;

d to apply the same principles to related areas such as friendly societies, medical insurance and annuities; and

e to minimise the additional administrative and compliance costs of the new provisions.

1.5 Purpose and Scope of the Consultative Document

This Document reviews the taxation of superannuation and life insurance and the regulatory regime in which it operates. It explains why changes in this area were considered desirable and why possible alternative policy responses were rejected. It also outlines a number of detailed measures to implement the announced policy so that interested parties can have an opportunity to present their views on implementation details before final decisions are made.

The main areas which require detailed consideration are:

- the basis on which the income of a superannuation fund is to be calculated;
- the basis on which the income of a life office is to be calculated;
- the taxation of annuities;
- an appropriate regulatory regime for superannuation and life insurance;
- appropriate guidelines to achieve a smooth transition to the new tax regime for superannuation and life

insurance and to facilitate, where necessary, the renegotiation of superannuation schemes;

- the taxation of friendly societies; and
- the taxation of medical insurance.

1.6 The Consultative Committee

The Government invites the public to make submissions on the matters set out in this document. Submissions will also be sought on the Government's decision to remove the income tax exemption for charitable bodies and sporting organisations. These areas will be the subject of a separate consultative document to be released in March 1988.

A Consultative Committee has been appointed to receive and consider submissions on superannuation, life insurance, related areas, charitable bodies and sporting organisations. The Committee is comprised of:

- Dr Donald Brash (Chairman), Managing Director of Trust Bank Holdings Limited;
- Dr Geoff Harley, a tax partner with Rudd Watts and Stone, barristers and solicitors;
- Mr Robin Oliver, a manager with McLeod Lojkine Associates, chartered accountants;
- Mr Neil Malley, Director, William M Mercer-Ericksen Ltd, consulting actuaries;
- Mr John Drage, a partner with KPMG Peat Marwick, chartered accountants.

In addition, the Government Actuary, Mr Allan Archer, will act as technical adviser to the Committee.

The Committee's terms of reference are:

a to receive public submissions on matters concerning the implementation and operation of the measures proposed in this consultative document as well as the announced measures concerning the taxation of charitable bodies and sporting organisations;

b to report to the Minster of Finance on:

i matters covered in this consultative document, or raised in submissions concerning the implementation and administration of the taxation and regulatory changes to superannuation, life insurance and related areas;

ii possible amendments to the detailed changes set out in this document which, while consistent with the Government's policy announcements and policy objectives, would assist their smooth introduction and administration; and

iii the most effective means of implementing the announced changes to the taxation of charities and sporting bodies; and

c to prepare draft legislation to give effect to the recommended means of implementing the Government's announced policy changes in the areas of superannuation, life insurance, related areas, charitable bodies and sporting organisations.

The Committee is to report to the Minister of Finance by 29 April 1988 on those matters which need to be implemented in order to

allow the changes to the taxation treatment of superannuation to be implemented. It is to report to the Minister of Finance on the remaining items in its terms of reference relating to superannuation and life insurance by 27 May 1988.

1.7 Submissions

Submissions on those matters raised in this consultative document should be lodged by 8 April 1988. A date for submissions on the tax treatment of charitable bodies and sporting organisations will be announced when the consultative document on those areas is released in March. All submissions should be on A4-size paper, typed in double space on one side of the page only and should contain a brief summary of their main points and recommendations. Please send a total of 8 copies.

Submissions should be sent to:

The Chairman,
Consultative Committee on Superannuation,
Life Insurance and Related Areas,
c/- The Treasury,
PO Box 3724,
WELLINGTON

All submissions received by the due date will be acknowledged.

1.8 Outline of the Document

To allow for the earliest possible release of material relating to the Government's detailed proposals for transition to a non-concessionary regime, the document has been split into two volumes for separate release.

Volume 1 is divided into 3 parts. Part 1 canvasses the subject matter of the review. It includes this introductory chapter plus a general chapter on superannuation and life insurance.

Part 2 considers policy aspects behind the taxation of savings. It has chapters on the the income taxation of savings, the past concessionary tax treatment of superannuation and life insurance, the tax policy defects of that tax regime, and arguments which have been advanced for maintaining that concessionary regime.

Part 3 details the announced changes to the taxation of savings accumulated through superannuation schemes and life offices. Chapters cover the tax treatment of savings in a superannuation scheme, the tax treatment of savings in a life office, transitional issues, and the regulatory regime for superannuation.

Volume 2, which will be available approximately one week later than Volume 1, considers the remaining issues in this review. Chapters cover the taxation of life offices, the regulation of life offices, the taxation of annuities, friendly societies and medical/sickness insurance.

1.9 <u>Meaning of the Terms Used</u>

A glossary of the terms used is appended at the end of this document.

APPENDIX A1.1
GOVERNMENT STATEMENTS

PRESS STATEMENT

THE MINISTER OF FINANCE
HON. R O DOUGLAS

10 February 1988

Finance Minister Roger Douglas today announced the following detail of implementation of aspects of the 17 December 1987 economic statement.

BUSINESS AND COMPANY TAX REFORM

Cabinet has agreed to the following business and company tax measures:

. the rate of tax for resident companies for 199/89 will be 28 percent, and for non-resident companies 33 percent. Other tax rates and rebates which are aligned with the company tax rate will be adjusted accordingly;

. the rate of fringe benefit tax for employer superannuation contributions will be 24 percent;

. legislation implementing the announced changes to the assessment of provisional tax and the taxation of co-operatives and producer boards will be introduced early this year;

. the deductions under sections 145, 146, and 147 of the Income Tax Act relating to donations will be abolished from 1 April 1988;

. the removal of the tax exemption for sporting bodies will be deferred until 31 March 1989, to allow time for interested parties to make submissions to the Brash Committee considering this and other issues;

- the process of consultation and implementation for the international tax and company shareholder imputation proposals will proceed as announced;

- the consultative document on superannuation and life insurance will be available before the end of the month.

Cabinet has now received the legal opinion from the Solicitor-General regarding the superannuation and life insurance tax changes announced in the 17 December statement.

This confirms the constitutional validity of the Government's announcement to end the tax concessions for superannuation and life insurance contributions from 17 December 1987.

Cabinet has agreed to the early introduction of legislation to give effect to this measure as originally announced.

The rate of tax for the income of superannuation schemes will be 25 percent from 1 April 1988. The rate of tax for life offices is yet to be determined following consultation.

INDIRECT TAXATION

Cabinet has decided that:

- the proposed $200 million cut in excise duties on fuels from 1 April 1988 will now be postponed and reconsidered;

- as announced, GST will not be increased before 1 October 1988;

- the one month return period for registered traders with a turnover exceeding $24 million will proceed from 1 April 1988;

- GST base-broadening measures to treat business activities of non-profit bodies in a similar manner to other registered traders will be deferred until 1 October 1988.

PERSONAL TAX

Cabinet has decided that the personal tax rates and other related tax rates for the 1988/89 income year will be based on the following measures, to take effect from 1 October 1988:

- the scale of marginal personal tax rates will be 24 percent up to $30,875 p.a., and 33 percent above that level;

- in addition, there will be a rebate of 9 percent of taxable income up to a maximum of $855 in a full year, abating at 4 cents in the dollar between incomes of $9,500 and $30,875. Eligibility for the rebate has yet to be finalised;

- consequential adjustments will be made to the National Superannuation surcharge and Family Support. These will maintain the present net position under these schemes;

- the charitable donations and school fees rebate, and dependent relative rebate will be abolished from 1 April 1988;

- the deduction for most employment-related expense will be abolished from 1 April 1988;

- from 1 April 1988, the present housekeeper rebate will be enhanced and expanded to bring in a wider range of childcare expenses. Details have yet to be finalised.

Cabinet and the Ad Hoc Committee will continue to work on the other measures in the 17 December statement.

The fiscal impact of the measures announced will be positive in 1988/89. In the medium term the continued attainment of improvements in the structural fiscal position will require further attention to be given to the quality and level of government spending and revenue.

These announcements confirm the tax environment for businesses for 1988/89, prior to finalising the other tax and income maintenance announcements in the 17 December economic statement.

They give certainty for business and individuals to plan for the year ahead, while allowing the Government sufficient time to work through the implementation of the remainder of the 17 December statement.

CHAPTER 2 - SUPERANNUATION AND LIFE INSURANCE

2.1 Introduction

As both repositories for savings, and as sources of loanable funds, superannuation schemes and life offices play a significant role in channelling funds from savers to borrowers. In addition, they have important roles in their specialised functions of providing retirement benefits and insuring against risk. This chapter provides a brief survey of the role of superannuation and life insurance in the New Zealand financial system, the function of superannuation schemes and life offices, and the various types of schemes and offices. More detailed information is provided on the two largest superannuation schemes (the Government Superannuation Fund and the National Provident Fund). As well as providing an overview of superannuation and life insurance, this chapter highlights the importance of an appropriate tax and regulatory treatment of superannuation and life insurance to the health of the economy.

2.2 Superannuation and Life Insurance in the New Zealand Financial System

Superannuation funds and life offices constitute a substantial part of the New Zealand financial system. In 1987, superannuation schemes had total assets of almost $11.4 billion (including superannuation funds managed by life offices). In March 1987 the major New Zealand assets of life offices stood at over $10 billion.

Table 2.1 outlines the growth in the assets of private superannuation schemes over recent years excluding those managed by life offices. Table 2.2 provides data on the Government Superannuation Fund and Table 2.3 data on the National Provident Fund (these funds are not included in Table 2.1). All three tables indicate a fairly rapid growth in the assets of superannuation funds in recent years.

Table 2.1 Private Superannuation Scheme Funds

Year ended 31 March	Total Funds (Nominal[1] $ million)	Total Funds (Constant 1987[2] $ million)	Rate of Real Growth in Total Funds (% p.a.)
1968[3]	129	1056	
1977[4]	340	1200	1.4
1981[4]	1048	2139	15.6
1984[5]	1820	2753	8.8

Table 2.2 Government Superannuation Fund

Year ended 31 March	Total Funds (Nominal[1] $ million)	Total Funds (Constant 1987[2] $ million)	Rate of Real Growth in Total Funds (% p.a.)
1968	126	1032	
1977	402	1420	3.6
1981	705	1439	0.3
1984	1099	1663	5.0
1987	1686	1686	0.5

Table 2.3 National Provident Fund

Year ended 31 March	Total Funds (Nominal[1] $ million)	Total Funds (Constant 1987[2] $ million)	Rate of Real Growth in Total Funds (% p.a.)
1968	91	745	
1977	397	1401	7.3
1981	782	1597	3.3
1984	1316	1992	7.6
1987	2142	2142	2.4

Notes to Tables 2.1 to 2.3

1 Total assets expressed in dollars of the day.

2 Total assets expressed in terms of March 1987 dollars, previous years deflated by the Consumer Price Index - All Groups.

3 Source: Department of Statistics

4 Source: Reserve Bank

5 Source: Government Actuary

Table 2.4 traces the growth of life offices as financial institutions since 1949/50. Life offices experienced rapid growth in the 1950s and 1960s. That growth levelled off in the 1970s with a decline in the real value of assets over that decade. That has been offset by significant real increases in the value of assets over the 1980s.

Table 2.4 Total Assets of New Zealand Life Offices[1]

Year Ended 31 March	Total Assets (Nominal[2] $ million)	Total Assets (Constant 1987[3] $ million)	Rate of Real Growth (% p.a.)
1950[4]	216	3528	
1960[4]	499	5268	4.1
1970[5]	1251	9121	5.6
1980[5]	3262	7543	-1.9
1981[5]	3162	6341	-15.9
1982[5]	4052	6349	0.1
1983[5]	4550	6999	10.2
1984[5]	5179	7691	9.9
1985[5]	5952	7798	1.4
1986[5]	7037	8183	4.9
1987[5]	10433	10433	27.5

Notes

1 Includes superannuation managed by life offices.
2 Total assets expressed in terms on dollars of the day.
3 Total assets expressed in terms of March 1987 dollars, previous years deflated by the Consumer Price Index (All Groups).
4 Total assets of life offices.
5 Major assets of life offices.

Source: Reserve Bank of New Zealand

2.3 Characteristics of Superannuation

Superannuation is a means of providing, during a contributor's working lifetime, for the period when, through age or ill-health, the person is unable to earn a satisfactory income on which to live. It is also a means of providing a retirement income for those whose occupation requires them to retire early (examples are: airline pilots, the police, and the armed services). Most large firms administer their own superannuation schemes for employees, arrange the investment of the scheme's assets, and provide their own death, disability and pension cover. Smaller firms with less substantial superannuation schemes may prefer to arrange for one or more of these three areas to be serviced by an external agency. Firms with only a few employees are more likely to have a composite superannuation package provided totally by another organisation.

Life insurance companies offer services in all three areas (administration, investment and insurance cover) whilst banks and investment companies and other financial intermediaries offer administration and investment services. Specialist superannuation companies also exist specifically to provide administration and investment services for superannuation

schemes.

2.4 Coverage and Size of Superannuation Schemes

As in other Western countries, widespread private superannuation coverage in New Zealand is largely a phenomenon of the period since the Second World War. While some schemes date back to the last century - the 1850s for the first New Zealand civil service scheme and 1887 for the BNZ scheme - employee superannuation schemes generally did not develop until the early years of this century. Even then employee schemes were largely only available to state servants and employees of large companies with stable workforces. Internationally this tended to be large financial institutions, railways and utilities. In the 1980s superannuation coverage still tends to be limited.

Table 2.5 below shows that in 1987 employee superannuation schemes covered about 420,000 members with annual contributions of about $1.2 billion and funds of about $10.2 billion. Personal schemes covered about 210,000 members with contributions of $0.2 billion and funds totalling some $1.2 billion. The classification of superannuation schemes used in this table - employee, personal, pension, and lump sum - is explained below.

Table 2.5 Analysis of Superannuation Schemes in 1987

	Number of Contributors (000)	Contributions ($million)	Funds ($million)
Employee Superannuation Schemes			
a Pension Schemes			
Managed by life offices[1]	42	132	1,379
Managed by other financial institutions[2]	73	136	1,606
Government Superannuation Fund (GSF)	84	469[4]	1,686
Self-Managed[3]	75	275	3,848
Sub-total	274	1,012	8.569
b Lump Sum Schemes			
Managed by life offices	30	70	683
Managed by other financial institutions	26	31	320
Self-Managed	27	69	670
Sub-total	83	170	1,673
Total Employee Schemes	357	1,182	10,242

	Number of Members (000)	Contributions ($million)	Funds ($million)
Personal Superannuation Schemes			
a Pension Schemes			
Managed by life offices	37	28	108
Managed by other financial institutions	25	14	218
Self-Managed	2	2	5
Sub-total	64	44	331
b Lump Sum Schemes			
Managed by life offices	39	28	157
Managed by other financial institutions	63	46	430
Self-Managed	37	79	325
Sub-total	139	153	912
Total Personal Schemes	203	197	1,243
Total All Superannuation Schemes	560[5]	1,379	11,485

Number of Pensioners - 69,000

Notes

1. Schemes where a life office manages the scheme and generally provides investment services (without necessarily investing all the funds).
2. Schemes where a non-life office financial intermediary (including the NPF) manages the scheme and generally provides investment services (without necessarily investing all the funds).
3. Self-managed includes schemes where the administration is performed by an organisation which is not a financial intermediary. Many of these schemes will have appointed one or more life offices or other financial intermediaries to invest some of the funds.
4. Includes Government subsidy on an unfunded basis.
5. Double counting will exist in that some persons contribute to personal as well as employee schemes.
6. The figures are based on scheme financial years ending in 1987 (or earlier years if later figures are unavailable).
7. There are 3,600 approved employee schemes and 900 approved personal schemes. The number of employee schemes is very much lower than the number of employers involved because several organisations operate schemes which can embrace many small employers under a single master trust arrangement.

Source: Government Actuary

This means that only about 26 per cent of the labour force belong to an employee superannuation scheme. Even in the public service, participation is only about 60 per cent.

A substantial portion of superannuation funds are held in either the Government Superannuation Fund (GSF), which offers superannuation to all state servants, or the National Provident Fund (NPF), which provides superannuation for members of local

bodies, farm employees, members of the public, and members of employer-subsidised schemes. Privately administered superannuation funds, however, control a significant proportion - probably around 18 per cent of the funds of all superannuation schemes in existence.

2.5 Superannuation Scheme Participants

There may be up to four participants in superannuation schemes:

a employers: generally, it is the employer who establishes an employee superannuation scheme. Employers usually have a liability to contribute to such a scheme which can be regarded as part of the overall remuneration paid to employees;

b trustees: trustees are responsible for the legal custodianship of the scheme. Trustees must comply with trustee law and the Superannuation Schemes Act 1976;

c managers: trustees may delelgate the day to day management of the scheme to another person;

d members: members usually, but not always, have a liability to contribute to employee superannuation schemes. Under the Superannuation Schemes Regulations 1983, the minimum benefit payable to a member of an employee scheme cannot be less than the member's own contributions to the scheme. Often the terms of specific schemes will provide greater minimum benefits. In personal superannuation schemes (the distinction between personal and employee schemes is made below) the member is generally the sole contributor.

2.6 Classification of Superannuation Schemes

To be approved under the Superannuation Schemes Act 1976 (approval of the Government Actuary has been required in order to obtain concessional tax treatment), a superannuation scheme has had to be classified by the Government Actuary as either:

a   an employee pension superannuation scheme;or
b   a personal pension superannuation scheme; or
c   an employee lump sum superannuation scheme; or
d   a personal lump sum superannuation scheme.

A pension scheme provides most of the retirement benefit in pension form (up to 25% can be taken as a lump sum). A lump sum scheme provides all the retirement benefit in lump sum form. Personal schemes are schemes for the benefit of individuals other than as employees. Employee schemes are schemes established and operated for the benefit of the employees of a particular employer or group of employers. Employee schemes are further classified as:

(i) subsidised schemes: schemes to which the employer is liable to contribute;

(ii) non-subsidised schemes: schemes to which the employer does not contribute. (Employee non-subsidised schemes are quite rare.)

2.7 Types of Superannuation Scheme

There are two basic types of employee superannuation schemes:

a   defined contribution schemes, also known as cash accumulation schemes; and

b defined benefit schemes, also known as benefit promise schemes.

All personal superannuation schemes are defined contribution schemes.

Defined Contribution Schemes

The principal features of defined contribution schemes are:

a contributions are defined in advance, usually in employee schemes as a fixed percentage of each member's salary;

b the retirement benefit is derived simply from the accumulation, with interest, of the contributions paid to the scheme in respect of each member;

c the principle of allocated funding is employed. The contributions are invested as a common fund, but separate accounts are opened in respect of each member to which the trustees credit:

- contributions paid to the scheme by the member;

- contributions paid in respect of the member by the employer; and

- the member's share of the fund's investment earnings, usually on an annual basis; and

- (sometimes) a share of money left behind by employees who resign and do not receive the full extent of the employer's contributions.

d the retirement benefit may be paid to members as a

pension or lump sum depending on the classification of the scheme.

Defined Benefit Schemes

The principal features of defined benefit schemes are:

a the benefits payable are determined by formula, usually as a percentage of each member's average salary for a period before retirement multiplied by the number of years of membership of the scheme (or service with the employer). For example, a member's retirement pension for each year of membership might be 1.25 per cent of average annual salary over the last three years of service (generally such a salary is called the member's final average salary). Thus, after 40 years of membership the member would retire with a pension of 50 per cent of final average salary;

b usually each each member contributes a fixed percentage of salary, with the employer's contributions varying in order to meet the cost of providing the defined benefits;

c the adequacy of the employer's contributions (to provide the benefits promised) is examined regularly by an actuary, who may recommend changes in the contribution rate due to differences between the actual experience of the scheme and the initial assumptions. The Superannuation Schemes Regulations 1983 require an actuarial examination to be made at least every three years;

d generally the system of unallocated funding is employed. Separate accounts are not opened in respect of each member, as the benefit of each member is defined in advance;

e the trust deed usually provides a means by which the employer can reduce its contributions in the event that the

cost of providing the defined benefits becomes unacceptably high. Two examples are:

- power for the employer to reduce employer contributions at any time, in which case the trustee, after seeking actuarial advice, would adjust the benefits of the scheme or members' contributions or both; and

- power for the employer to direct the trustees to wind up the scheme, whereupon the assets of the scheme would be appropriated to the individual members, and be applied to provide for them;

f the retirement benefits may be paid to members as a lump sum or as a pension depending upon the classification of the scheme.

2.8 Life Insurance

The first life office was established in New Zealand in 1869. In 1883 there were five offices and the number had reached 15 by 1935. The number remained at this level until 1957. By 1984 the total number had grown to 36 offices, employing over 3,000 full-time staff.

The basic nature of life insurance as marketed in New Zealand means that life offices tend to accumulate large pools of funds for investment purposes. Many policies sold incorporate a substantial savings component as well as a death-risk element - in some policies the death-risk element is minimal. Thus life offices invest large sums of money to provide a return to policyholders consistent with their obligations under their life insurance contracts, while providing liquidity to meet immediate claims.

2.9 Types of Life Policy

The main types of life insurance policies are:

a term insurance: sometimes called temporary insurance, this provides a benefit on the death of the insured in much the same way as fire insurance provides a benefit in the event that the insured property is damaged by fire. The duration of a term policy may be for one year, a specified number of years, or until a selected age. In most cases, if the insured survives the specified period, no payment will be made by the life insurance company;

b whole of life insurance: this is similar to term insurance in that payment is made under the policy only on the death of the life insured. However, under a whole of life policy insurance cover is provided for the entire life of the insured and premiums remain unchanged for the duration of the policy. As a result, the annual premium for a whole of life policy is usually higher in the initial years than for a similar amount of term insurance. On the other hand, the premium as the insured grows older is lower than if a term insurance policy were to be renewed periodically over the same age range;

c endowment insurance: this is similar to whole of life insurance but provides for the payment of the sum insured on a specified date (the maturity date) or on the death of the insured if that occurs earlier. In other words payment of a benefit can occur before the death of the insured. A variation on endowment insurance is 'pure endowment', a savings-only policy which provides a fixed sum on the maturity date and an amount related to premiums paid should the insured die before the policy matures.

d unbundled policies: under these policies, the savings

component is explicitly identified and the return on savings is reported to the policyholder periodically. There can be flexibility in the death cover provided. Some policies, such as the single premium insurance bonds which have been very popular in recent years, provide minimal death cover. The popularity of these policies stems from investment performance and, in some cases, tax effectiveness.

Life insurance policies may also be divided into participating and non-participating policies. A participating policy is credited (usually by way of bonuses added to the sum insured of whole of life and endowment policies) with a proportion of any surplus made by the life office ater providing for its contractual obligations. A non-participating policy does not share in surpluses. Most term insurance policies are non-participating; most whole of life and endowment policies are participating. Unbundled policies fall into yet another group as they benefit directly from investment surpluses, but do not usually share in profits from other sources.

2.10 Life Offices and Superannuation

In addition to providing life insurance, life offices undertake a large amount of superannuation fund management. On the basis of figures provided to the Reserve Bank, about 34 per cent of life office premium income in the year ended March 1985 came from superannuation fund contracts.

Superannuation funds flowing to life offices may be invested in the office's general pool of assets and earn the average rate of return on all investment, or, in some cases, the superannuation payments may be used to purchase 'units' in an 'investment-linked' fund. In the latter case, the trustees of the superannuation fund nominate the types of investment they want. The life office then maintains separate pools of shares, property and fixed-interest investments which are revalued regularly so

that a value can be placed on the 'units' held in the name of each superannuation scheme.

2.11 The Government Superannuation Fund (GSF)

The GSF in its present form was established under its own Act of Parliament on 1 April 1948, amalgamating various funds which had been in existence since the 1850s. Its revenues consist of members' contributions, subsidies from the Consolidated Account, trading departments and other bodies (such as some State Owned Enterprises), and income earned on its investments.

Any state employee may belong to the Fund and, until 1 May 1985, membership was compulsory for permanent employees of the Government from the age of 17 to 24 years. Contributions are generally made by employees at the rate of 6.5 per cent of salary. Certain categories of employees contribute at other rates.

The principal objective of the GSF is the payment of a pension on retirement, which is usually around the age of 60. The pension is set as a percentage of average salary over the last 5 years, adjusted for inflation in salaries.

The broad principal on which the GSF operates is that members' contributions are built up with investment earnings in the Fund. These are used to pay part of the cost of retiring allowances, and spouse and children's allowances. The remainder of the cost of the benefits in any year is met by a subsidy paid by the Government and other employers of members. There is no direct relationship in any year between the amount of members' contributions and the amount of subsidy. The subsidy is fully spent in the year it is received, so that at the annual balance date the GSF consists entirely of members' contributions and investment income. Future liabilities are not met or funded each

year, so that the GSF is a partly-funded scheme. In this respect it is unique in New Zealand. All other schemes are funded, meaning that the expected future liability of the scheme is covered in advance by contributions from either members or employers.

2.12 The National Provident Fund (NPF)

The NPF was established with its own Act of Parliament in 1910 as a public service for a wide cross section of private contributors. It was explicitly designed as a vehicle for targeting and distributing government welfare assistance to 'the poorer classes of our community'. In return for a compulsory weekly contribution, the Government undertook to provide a state-subsidised pension plan, sickness insurance, family support measures, and a maternity allowance. The relative generosity and welfare intentions of the NPF are indicated by the fact that membership was initially means-tested.

The history of the NPF since its inception may be broadly characterised as a gradual movement away from its early social policy/welfare role, as its new pension schemes expanded and the non-pension and state-subsidised benefits of the initial Fund reduced. Today, the NPF is one of the largest providers of superannuation services in New Zealand. Schemes developed since 1969 have included no government subsidies (although the Fund is currently servicing government-subsidised contracts written before this time) and the present NPF resembles its 1910 precursor in name only.

Presently, the NPF manages the standard range of cash accumulation and defined benefit superannuation contracts. Approximately half of its contributor group come from a wide range of local authorities. All its schemes are funded.

2.13 Conclusion

The importance of superannuation schemes and life offices as repositories of savings, and as lenders and investors of the funds deposited with them, gives these institutions a substantial role in New Zealand's financial sector. To enable the financial sector to operate efficiently to the maximum benefit of the New Zealand economy, it is necessary that superannuation and life insurance be taxed in an appropriate way. This is becoming even more important as the traditional boundary lines between different financial institutions (such as trading banks and life offices) become more blurred. As noted by the Minister of Finance in his Preface to the Consultative Document on Full Imputation, "companies, superannuation funds and life offices are financial intermediaries which specialise in investing various forms of capital ultimately contributed by individuals. These intermediaries can, and indeed should, compete on their merits. The tax system should neither subsidise nor discriminate against them."

CHAPTER 3 - THE TAXATION OF SAVINGS

3.1 Introduction

The Government's general policy objective is to reform the taxation of superannuation and life insurance so as to reinforce the imputation and international reforms and apply a consistent taxation regime to the return on savings and investments. Taxation considerations should not then intrude to the same extent on the relative competitiveness of different financial institutions and the choice between different forms of investment. As well as enhancing economic efficiency in that way, a more consistent tax treatment of the returns from savings and investment should produce a fairer tax system.

A consistent tax treatment of the returns from savings and investments requires the general application of a single taxation method. That general method of taxation should be determined on the basis of a number of considerations including judgements on which method is: the most economically efficient, the fairest, the most compatible with overseas taxation regimes, the least costly to move towards, and the easiest to comply with and administer.

The Government has decided that an income tax treatment should be applied broadly to all forms of capital income. That has underlined the Government's taxation reform programme since 1984. This chapter explains the rationale behind that decision and identifies the implications for savings in general and superannuation and life insurance in particular.

3.2 Flows of Funds from Savings

There are three potentiallly taxable flows of funds associated with savings. These are:

a contributions to savings accounts - this is the income initially received by the saver in the form of, for instance, wages or salary from employment. This income becomes a contribution when it is deposited in a savings account;

b income accruing on savings - a common example being interest; and

c withdrawals from the account.

3.3 Income Tax Treatment of Savings

Under an income tax system all income is assessable as it is derived. Contributions are made from income which is subject to tax. In that sense contributions can be said to be taxable under an income tax regime. Income accruing is also taxable. Withdrawals, on the other hand, merely represent the conversion of an asset in the form of a positive savings account balance to an asset in the form of cash. Withdrawals do not constitute income of the taxpayer and are not taxed.

In general this is the tax treatment now applied to savings in a bank account. Deposits are made from after-tax income and are therefore taxed. Only if the amount deposited could be deducted from income in calculating a taxpayer's tax liability would deposits be exempt tax. Income accruing in the form of interest is also taxed. Withdrawals from the account are not taxed.

This income tax treatment of savings can be described as a taxed/taxed/exempt regime. Such a tax regime is illustrated diagrammatically in Table 3.1 below.

Table 3.1 Income Tax Treatment of Savings

Contributions	Taxed
Interest income	Taxed
Withdrawals	Exempt

If applied consistently to all forms of saving, such a tax system would tax all income involved in the savings process as that income accrues and, in that way, achieve a uniform tax treatment of savings.

An alternative tax treatment of savings is set out in Table 3.2 below. A deduction from other income is allowed for the amount of contributions made. Offsetting this, withdrawals are made taxable. Interest income remains taxable. Such a regime can be described as an exempt/taxed/taxed regime.

Table 3.2 Alternative Tax Treatment of Savings

Contributions	Exempt
Interest income	Taxed
Withdrawals	Taxed

An exempt/taxed/taxed regime is not an income tax regime but is equivalent to an income tax (ie a taxed/taxed/exempt) regime under certain restrictive assumptions. The individual's tax rate must be constant over time and the interest rate at which the taxpayer is prepared to lend money must be equivalent to the tax rate at which the Government is prepared to borrow money.

3.3 Expenditure Tax Treatment

One of the criticisms which has been levelled at an income tax is that it penalises savings (and investment) by taxing both the income which is saved (ie contributions) and the interest on the savings. This causes consumers' choices to be biased towards current consumption and away from future consumption. In other words, an income tax system tends to encourage taxpayers to spend their money now rather than to save it for a later date.

An expenditure tax is an alternative form of taxation which, unlike an income tax, does not impose a penalty on savings. Under an expenditure tax, only income which is spent on consumption is taxed. Income which is saved (or invested) is not taxed. As a result, an expenditure tax can be represented as an exempt/exempt/taxed regime.

Contributions or savings are not taxed, interest income which is not withdrawn is not taxed, but withdrawals which are spent are taxed. This type of taxation system is outlined in Table 3.3 below.

Table 3.3 Expenditure Tax Treatment of Savings

Contributions	Exempt
Interest income	Exempt
Withdrawals	Taxed

To achieve this expenditure tax affect, tax may be levied only on goods and services which are consumed (an indirect expenditure tax). GST is an example of an indirect expenditure tax. Alternatively, an expenditure tax may be levied directly on income which is spent by allowing taxpayers to deduct from taxable income all savings and investments and by taxing in full

all reductions in the level of savings and all borrowings. Such a tax system is known as a direct expenditure tax.

New Zealand currently raises most of its tax revenue by way of a mix between what is in general a direct income tax and an indirect expenditure tax (GST). The Government could rely almost totally on an expenditure tax for revenue purposes by placing sole reliance on GST. However, that would require a GST rate in excess of 40 per cent. Such a high GST rate would be difficult to sustain.

Alternatively, the same effect could be achieved by replacing the income tax with a direct expenditure tax. However, on the basis that the level of savings is positive, a comprehensive expenditure tax base would be narrower than a comprehensive income tax base. Expenditure tax rates, therefore, would need to be higher than income tax rates if the same level of public spending were to be funded. As a result, the pre-tax income required to sustain the same level of consumption would increase. This would tend to increase tax-induced disincentives to work and effort.

It is not clear whether the removal of the penalty that an income tax imposes on savings would more than offset the increased disincentives to work which would result in high expenditure tax rates. Both the United States of America and the United Kingdom have closely considered the direct expenditure tax option.

However, more recent investigations (Tax Reform for Fairness Simplicity and Growth, US Treasury 1984, and How should Business be Taxed?, Paul Bevin 1985), have highlighted the serious obstacles to the implementation of a direct expenditure tax. These include:

- no country has a broad-based direct expenditure tax, so the

practicability of such a tax has not had the years of testing to which income taxes have been subject;

- significant problems would arise in integrating a direct expenditure tax in New Zealand with a world in which our trading partners operate what are predominantly income tax regimes;

- their could be a perceived unfairness in a tax which results in an increase in the tax rate on wage income while exempting income from capital;

- there would be major transitional problems of moving to a direct expenditure tax if existing owners of assets are not to be penally taxed; and

- it would be more complex for the typical wage earner to operate than an income tax since savings would need to be deducted from income, and reduced savings and borrowings added to income, to derive tax liability.

These considerations have led the Government to the conclusion that New Zealand's direct tax base should be income. Reforms of the income tax system have as their aim a more comprehensive tax with lower and less variable rates. That is consistent with the reforms in a number of overseas countries including Australia and the United States of America.

The tax penalty which an income tax regime imposes on savings has been mitigated by the introduction of GST and the removal of income tax concessions. Those moves have made substantial reductions in income tax rates possible.

3.5 Inflation and the Taxation of Savings

The 1982 Task Force on Tax Reform (the McCaw Committee) argued that, under an income tax, savers are disadvantaged in times of inflation because the inflation-compensation element of interest is taxed as income together with any element of real return on investment. In inflationary conditions, a nominal income tax on savings (which taxes inflationary gains) amounts to a tax on real (non-inflationary) income plus a tax on wealth. For example, if an interest rate of 12 per cent per annum is paid when the annual inflation rate is 10 per cent, tax is levied on the full 12 per cent even though the first 10 per cent serves only to maintain the purchasing power of the taxpayer's capital.

Inflation, combined with an income tax, has a number of often undesirable effects. There are two, not mutually exclusive, responses. First, the Government can maintain the monetary and fiscal policies necessary to reduce inflation on a permanent basis. Secondly, the income tax system can be moved on to a real income tax base (which does not tax inflationary gains) by appropriate methods of indexation. However, there are a number of practical difficulties in moving to a real income tax system. While the possibilities in that regard can be explored, there is general international agreement that the most efficient and fairest tax system is likely to be the one which is as comprehensive as possible. That applies whether or not it results in the taxation of inflationary gains.

3.6 Application to Superannuation

Superannuation is one of a number of ways in which a person can accumulate savings.

Under a typical subsidised defined-contribution employee

superannuation scheme, an individual makes regular contributions to a fund to which the employer also contributes. This fund is invested so as to earn income. Accumulated contributions, plus the accumulated earnings of the fund, are used to pay benefits on retirement. Benefits may be in the form of a lump sum or a pension.

Non-subsidised defined-contribution employee and personal superannuation schemes are the same except there are no employer contributions.

Defined-benefit schemes have the added feature that benefits are not necessarily related to the contributions of the <u>individual</u> scheme member. Benefits must, however, be related to the total contributions made by the employer as well as by scheme members. While two scheme members may receive different benefits despite having paid the same amount into the scheme (because of, for instance, early withdrawal by one member), the nature of the scheme as a savings vehicle remains. All that has happened is that the employer contributions are higher for the person receiving the higher benefits.

As with other savings media, there are three financial flows associated with a superannuation scheme. These are:

a <u>contributions</u> - the contributions to the scheme paid over by individuals and their employers. These are comparable to bank deposits and, under an income tax regime, should be made from taxed income with no deduction;

b <u>the annual fund accumulations</u> - the amount earned each year by investing the pool of money representing past contributions and accumulations. These are comparable to interest earnings and, under an income tax regime, should be taxed at the marginal rate of scheme members as the earnings

are derived by the fund; and

c the emerging benefit - the pension or lump sum paid out to scheme members. This is comparable to a withdrawal from a bank account. Under an income tax regime it should be free of tax.

3.7 Application to Life Insurance

Life insurance is less obviously a form of savings. A one-year term insurance policy is mainly simply an insurance contract and involves no significant savings element.

As with other forms of insurance, such as fire insurance, an annual term policy involves the pooling of risks by policyholders, all of whom are covering themselves in case in that year they suffer the loss insured against (in the case of a term life insurance policy this is death). If they do suffer the insured loss, a claim is paid from the pool of funds made up of premium payments. If they do not suffer the loss, policyholders receive no payment; they have simply contributed to the pool of funds from which the loss sufferers draw.

Most life policies are, however, not annual term insurance. Whole of life, endowment insurance and unbundled savings policies predominate. While term insurance involves a negligible savings element, this is not the case with these other policies.

A feature of a typical whole of life or endowment policy is that the premium remains constant throughout the term of the policy even though the risk insured against (death) increases with the age of the insured. Whereas this increasing risk is reflected in rising premiums for annual term insurance policies, the constant premium is obtained by setting the premium initially at a higher level than is required to cover the risk of the insured's death.

The 'excess premium' in any year is invested by the insurance company. As the policyholder ages, the difference between the premium and the amount required to insure the full sum insured is made up by drawing from a fund consisting of past excess premiums plus the investment earnings of that fund.

The situation is the same as if the insured had taken out an annual term insurance policy and established his or her own separate fund in a bank account. The insured would pay a constant annual amount but, in the early stages while the term insurance premiums are low, part of this sum would be used to build up the fund. As the term insurance premiums increased, the policyholder would draw from the fund to make up the shortfall between the constant sum and the higher premiums.

There are thus two distinct elements contained in the typical whole of life and endowment policy:

a a pure insurance element - representing the risk the life insurance company takes each year the policy remains in force that the death of the insured will occur that year; and

b a savings element - representing the amount the life insurance company puts away (or invests) to cover the future increase in the risk of the insured's death as he or she ages.

By definition, the newer unbundled contracts explicitly separate these elements.

The pure insurance element is the same as a term insurance policy. The savings element is the same as a deposit in a bank account. It is the savings element in most life insurance policies which makes life insurance a form of saving whereas fire

insurance, for instance, is not.

This analysis enables the financial flows associated with life insurance to be placed in a similar framework to that developed for saving through a bank account or a superannuation scheme. Again there are three financial flows:

a personal contributions - the premiums paid by the policyholder. Under an income tax this should be paid out of after-tax income with no deduction;

b annual fund accumulations - the amount earned each year by the life office from investing that part of each premium which is put aside to be drawn upon when the premiums paid by a policyholder are insufficient to cover the sum insured. Under an income tax, annual fund accumulations should be taxed at the marginal tax rates of the policyholders; and

c the emerging benefit - this is the benefit paid out when a policy matures because of the death of the insured or the expiry of time. It is the equivalent of the withdrawal of bank account funds and under an income tax should be free of tax.

3.8 Conclusion

The income tax is a long-term feature of the New Zealand tax system. Other options, such as replacing the income tax with total reliance on expenditure taxes are not viable in this timeframe. By accepting an income tax one must accept the economic costs which such a tax imposes, such as the penal treatment of savings. However, those economic costs can be minimised by making the income tax as comprehensive as possible and by making tax rates low and less variable.

Under an income tax, savings should be made out of after-tax income, earnings from investing the savings should be taxed as they are derived, but withdrawals or benefits should not be subject to further tax.

Both superannuation and life insurance are vehicles for accumulating savings. If the income tax system is to be applied consistently to all forms of saving, this means that contributions or premiums should be made out of after-tax income, investment earnings of superannuation funds and life offices should be taxed at the marginal rates of scheme members and policyholders, but benefits (whether lump sum or pension) should be free of tax.

CHAPTER 4 - TAX PREFERENCES FOR SUPERANNUATION AND LIFE INSURANCE SAVINGS

4.1 Introduction

In general, superannuation and life insurance have not been subject to the normal income tax treatment for savings outlined in Chapter 3. Instead, these forms of saving have benefitted from special tax preferences. This has taken the form of exemptions for income saved through a superannuation scheme or life office and exemptions for, or low tax rates on, superannuation and life office investment earnings.

This chapter briefly canvasses the historical background to these concessions and, in broad terms, describes the taxation regime applying to life insurance and superannuation up to the end of 1987. The taxation regime described is that of a person who entered a superannuation scheme or took out a life insurance policy at the beginning of December 1987. Further complexity to the tax system is added by transitional measures incorporated into the law as a result of past changes to the tax system. Those special rules are described in Appendix A4.1.

The tax rules described in this chapter are summarised in Appendix A4.2.

4.2 Historical Background

Superannuation and life insurance preferential tax treatment has a long history. A deduction for life office savings can trace its origins back to the late nineteenth century English precursor of the income tax. This was a tax on various forms of expenditure. With the outbreak of the Napoleonic Wars, the Government had to increase its revenue from taxation by increasing tax rates. To limit the level of taxation to which a person was liable, total tax liability was limited to 10 per cent

of a taxpayer's income. In calculating income, life insurance premium payments were excluded. Such an exemption was valid when the tax system aimed to tax expenditure and not income. However, when William Pitt moved the tax system from a tax on expenditure to a tax on income, the then established life insurance exemption continued in place. It was then incorporated into New Zealand's tax system when the income tax was introduced here in 1891.

The life insurance premium exemption was extended to superannuation contributions in 1915. The income derived by a superannuation fund was exempted tax as early as 1916. Again, New Zealand mirrored a similar exemption in the United Kingdom. It has been argued that the United Kingdom exemption was introduced because, as a result of high thresholds of income before a person became liable to income tax, most superannuation scheme members would not have had to pay tax if they had derived investment income directly rather than through a superannuation scheme.

4.3 The Taxation of Superannuation Savings

For taxation purposes, there have been two main types of superannuation scheme:

a lump sum schemes - where benefits are paid as a lump sum; and

b pension schemes, which include the Government Superannuation Fund - where benefits are paid as a pension.

Different tax rules have applied to each of these. As a general rule pension schemes have not been taxed on their net investment income but pension benefits have been taxable. For lump sum schemes, on the other hand, investment income has been taxable but lump sum benefits have been tax-free.

A distinction has also been drawn between employee and personal schemes. As a general rule employee schemes have received more preferential treatment than personal schemes. The end result is that whereas personal lump sum schemes have been taxed on a basis which approximates income tax treatment, employee pension schemes have received very favourable tax treatment compared to an income tax.

This discussion relates to schemes approved by the Government Actuary. Non-approved schemes have not received preferential tax treatment. The taxation of non-approved schemes is outlined in Appendix A4.1.

Superannuation Contributions

Superannuation contributions can be paid by either the scheme member or by the member's employer.

Under an income tax, member contributions to a superannuation scheme should not be deductible to that employee and thus should be made out of after-tax income. However, under our income tax system member contributions, up to set limits, have been deductible from the member's assessable income if the scheme is a pension scheme (employee or personal) or a susidised employee lump sum scheme. Contributions to other schemes (e.g. non-subsidised employee and personal lump sum schemes) have not been deductible and thus the income from which they have been paid has been taxed. The limits on contributions which are exempt from personal income tax have been $1,400 per annum if the member did not belong to a subsidised scheme and $1,200 per annum otherwise. Those limits applied to the aggregate of qualifying superannuation contributions and life, personal accident and sickness insurance premiums. [Section 59 of the Income Tax Act 1976 refers]

Employer contributions to a superannuation scheme should, under an income tax, be deductible to the employer as they are part of labour costs and thus one of the employer's income-generating expenses. On the other hand, as part of an employee's remuneration, those contributions should be assessable to the employee. Under our income tax, employer contributions have been deductible to the employer but with restrictions which limit the amount of deductible contributions and which disadvantage the self-employed and employees who have major stakes in the employing company. In general, no tax has been levied on that part of an employee's income consisting of employer superannuation contributions on his or her behalf.

For employer superannuation contributions to be deductible to the employer, the law has required those contributions to be made to an employee subsidised scheme. A deduction has not generally been permitted for contributions in respect of an employee who holds an interest in an employing company totalling 20 per cent or more. In other cases, the amount deductible has been limited to the smaller of the amount the employer was required to contribute to the scheme and 10 per cent of the total earnings of all employees who were scheme members. [Section 150 of the Income Tax Act refers]. Employer contributions to a superannuation scheme which does not qualify as a subsidised employee scheme have not been deductible to the employer. [Section 106(1)(m) of the Income Tax Act refers]

Two features of this regime have disadvantaged the self-employed and those holding large interests in an employing company. The first is the denial of deductions for contributions in respect of those holding a 20 per cent or more interest in the employing company. The second is the denial of deductions for personal schemes given that a scheme to which non-employees belong has in general been classified as a personal and not an employee scheme.

In general, employer superannuation contributions (whether or not deductible to the employer), have not been regarded as assessable income of the employee. Instead, they have been regarded as income of the trust administering the scheme, and under the Income Tax Act that income has not been assessable to the trust. [Sections 61(21) and 225(4)(b) of the Act refers]. Such contributions have also been specifically exempted from the alternative form of taxing employee remuneration - fringe benefit tax. [Section 336N(1) of the Income Tax Act refers].

However, in certain circumstances it has been possible for employer contributions to give rise to an employee income tax liability. One instance where this could occur is where the employee had a 20 percent or more interest in an employer company controlled by less than five people. The employer contributions could then have been a deemed dividend assessable in the hands of the employee under section 4(2) of the Income Tax Act. In some cases, the employee could have been liable to tax for employer contributions on the basis that the contributions constituted monetary remuneration of the employee, or it is possible that section 75 of the Income Tax Act could have operated so as to deem the contributions to have been derived by the employee.

Annual Fund Accumulations

This is the investment income of a superannuation fund. Under an income tax such income should be taxable as it is derived and it should be taxed at the marginal tax rates of the scheme members. Our income tax system has not operated in that manner.

A distinction has been drawn between pension schemes (including the Government Superannuation Fund) and lump sum schemes. Pension schemes have not been subject to tax so that investment income derived by such schemes is tax-free. [Section 61(21) of the Income Tax Act refers].

Lump sum schemes (pre-1982 lump sum schemes are considered in Appendix A4.1), on the other hand, have been subject to tax on their net investment income. The rate of tax has been set at 33 cents in the dollar. Tax has been levied on gross income minus expenditure. The Income Tax Act has defined gross income as investment income including any profits on the sale of investments (defined as sale price minus cost price) and to exclude contributions to the scheme. Expenditure has been defined as investment losses and expenses, including any losses on the sale of investments, and to exclude any costs incurred in developing, marketing, selling, promoting or advertising a scheme. It is to be noted that one result is that lump sum superannuation schemes are taxed on any realised capital gain which they may make. This applies even if those gains would not normally be subject to tax, in other words, even if the assets were purchased by the scheme as a long-term investment.

It should be further noted that the tax rate has been set at 33 cents in the dollar, a rate which may or may not have approximated the marginal rate of individual scheme members. [Section 225 of the Income Tax Act refers].

Superannuation Scheme Benefits

Superannuation scheme benefits can be in the form of a lump sum payment, a pension, or a combination of the two. Under an income tax all benefits should be tax-free. Under New Zealand's tax system lump sum benefits have been payable free of tax but pension benefits have been taxable [section 65(2)(j) of the Income Tax Act refers].

The exemption from tax for lump sum benefits means that where it has been possible to pay benefits from a pension scheme in a lump sum form, those benefits have been payable free of tax. In that way the scheme member could take advantage of the special tax preferences provided to pensions schemes (such as tax-free annual

accumulations) while not being levied tax on the benefits paid out.

In general, the Superannuation Schemes Act 1976 and the regulations made under that Act have required a pension scheme's trust deed to stipulate that benefits under the scheme are payable in pension form. However, there are a number of exceptions which have allowed pension scheme benefits to be paid as a lump sum.

First, the law has allowed a pension scheme to provide that up to 25 per cent of a pension entitlement could, on retirement, be capitalised and paid to the recipient as a lump sum.

Secondly, the trust deed of a pension scheme has been able to allow benefits to be paid in a lump sum in the event of the member's death, permanent incapacity or permanent emigration.

Thirdly, the law has allowed the trust deed of an employee pension scheme to provide for lump sum benefits to members who withdraw from the scheme on ceasing employment with the existing employer. If the employee is under age 50, the trust deed has been able to allow all benefits to be paid as a lump sum. If the employee is over 50, the trust deed has been able to allow only employee contributions plus interest to be paid as a lump sum. Members of the GSF have been able to withdraw from the scheme and receive lump sum benefits without the need to change employment.

Fourthly, an employee pension scheme's trust deed has been able to provide that, on termination of the scheme, benefits may be provided to members as lump sums except that, for members over age 50 that part of the benefit arising from employer contributions has had to be paid as a pension.

Finally, provision has been made for the trust deed of an

employee lump sum scheme which has been converted to an employee pension scheme to pay out lump sum benefits as if the scheme had remained a lump sum scheme.

Thus, although the general intent of the law has been to require pension scheme benefits to be paid out as taxable pensions, there are a number of exceptions enabling a considerable proportion of pension scheme benefits to be paid as tax-free lump sum benefits.

Furthermore, it has been possible to split pensions between a retired member and other persons, thus generally lowering the amount of tax payable on the pension.

4.4 The Taxation of Life Insurance Savings

Savings through life insurance have been taxed on a similar basis to personal superannuation schemes. Most life insurance policies offer lump sum rather than pension benefits. Thus life insurance savings have been taxed on a similar basis to personal lump sum superannuation schemes which, as noted above, approximates income tax treatment. As a result, life insurance savings generally receive a low level of tax preference. The rules which have governed the tax treatment of life insurance savings are outlined below.

Premiums

Just as superannuation contributions can be paid by either an employee or his/her employer, so life insurance premiums can be paid by either of these two parties.

Turning first to non-employer paid premiums. If the benefits under the policy are a pension for life from age 60 or the return of premiums and bonuses in the event of earlier death, then the

policy is a "policy of pension insurance" and premiums amounting to up to $1,400 per annum have been deductible from assessable income. Such policies though are quite rare. For any other form of life insurance (e.g. the usual type of policy offering lump sum benefits on maturity or death), no deduction has been available and premiums have been effectively paid out of after-tax income. [Section 59 of the Income Tax Act refers].

Where the premiums are paid by the employer but the benefits under the policy go to the employee, premium payments have been deductible to the employer as part of its normal cost of labour. Unlike superannuation contributions, there has been no special restriction on the amount the employer can deduct.

Premium payments by the employer have generally been included in the taxable income of the employee as "expenditure on account of the employee" and thus as "monetary remuneration" which is assessable under section 65(2)(b) of the Income Tax Act. Where the premium payment is included in the employee's assessable income, there is no fringe benefit tax liability. However, certain life insurance premium payments have been explicitly excluded from the statutory definition of expenditure on account and have therefore been excluded from employee income. Broadly these are life insurance policies which constitute or are part of a superannuation scheme, and policies with benefits payable or distributable only on the death of the employee (with subsidiary sickness and accident benefits allowed). Where the premium payment is not included in the employee's assessable income, fringe benefit tax has been payable.

There has also been a fringe benefit tax exemption for employer-paid premiums on personal accident or sickness insurance policies and approved funds providing benefits solely in respect of personal accident, disease, or death. [Sections 2, 59, 65(2)(b) and 336N(1) of the Income Tax Act refer].

Where the premium is paid by the employer and the employer benefits out of the proceeds of the policy, the Inland Revenue Department has regarded the premiums as being deductible only if the policy is a temporary or term policy. Otherwise no deduction has been allowed.

Annual Fund Accumulations

New Zealand's income tax system has adopted the approach of considering life offices as a conduit through which income passes to policyholders. Rather than attempting to tax the policyholder on his/her share of the income of the life office, tax is levied on the conduit (the life office). Thus the life office is taxed as a proxy for the policyholder and is not taxed in its own right.

That taxation approach has formed the basis for the taxation regime which has governed the business of life insurance as set out in section 204 of the Income Tax Act. The policyholder 'income' which the section has tried to tax is the income generated by accumulated premiums. That is gross investment income of the life office less the expenses incurred by the life office in earning that income.

Gross investment income is the total revenue received from investments. Premiums have been excluded from assessable income since it is only income generated from premiums which has been the object of taxation. Dividends from company shareholdings have been included in taxable investment income. Normally dividends received by companies (other than life insurance companies) are not included in assessable income. However, the life office is paying tax on behalf of individual policyholders who would be taxed on such dividends if they received them directly. The life office is therefore taxed on dividends in its role as proxy for policyholders.

Life offices are also taxed on any profit on the sale or disposal of investments, although unrealised gains due to asset revaluations are not assessable. This means that life offices have been taxed on realised capital gains even where the asset was acquired for the purpose of long-term investment and would not have given rise to a tax liability if the policyholder had acquired the asset directly.

Expenses incurred in gaining investment income, as well as realised losses on the sale or disposal of investments, have been deductible from gross investment income. Expenses involved in gaining premiums (for example the commissions of agents and advertising expenses) have not been deductible. It has been argued that in soliciting for life insurance business, life offices are, in a sense, performing the same role as other financial intermediaries in marshalling funds which are subsequently invested. It then follows that expenses such as agents' commissions are similar to the salaries of bank tellers and should be deductible. The counter argument is that life offices, unlike banks, have been taxed in substitution for taxing policyholders on their investment income. Premium expenses are not equivalent to any expense the policyholder would incur in deriving investment income directly. Thus, unless the basis for taxing life offices were changed, such expenses should remain non-deductible.

A life insurance company incurs general management and indirect expenses which relate to both gaining premiums and earning investment income. A portion of these costs ave been attributed to the earning of investment income and have been deductible. The remainder have been non-deductible. Apportionment has been on the basis of the ratio of investment income to gross revenue.

Life offices have, in effect, not been taxed on investment income attributed to funds held in respect of certain mortgage repayment policies, exempt superannuation funds, and annuities. This

apportionment has been made on the basis of the ratio of such liabilities to the total life insurance liabilities at the end of the income year.

Because they have been taxed as a proxy for the policyholder, life offices have not been taxed at the company rate. Instead the rate of tax levied on life office net investment income has been 33 cents in the dollar. That rate is supposed to reflect the marginal tax rate of policyholders. Obviously it has been concessional for policyholders on higher marginal tax rates and penal for those on lower marginal tax rates.

Life Insurance Benefits

The general rule has been that lump sum life insurance benefits have not been taxable in the hands of the recipient, but pension benefits have been assessable.

One exception has been a policy taken out by an employer on the life of an employee. The Inland Revenue Department has taken the view that if the policy is an endowment or whole of life policy then the benefits are not taxable. However, if:

a the policy is taken out on the life of a "key" employee; and

b the purpose of the policy was compensation for loss of profits; then

the benefits, over and above premium payments made, have been considered taxable even if received as a lump sum. If the policy is a term insurance policy, the Inland Revenue Department has regarded all benefits as taxable, again even if received as a lump sum.

4.5 Conclusion

The tax treatment of superannuation and life insurance savings is summarised in the table presented in Appendix A4.2. The taxation of these forms of saving has departed significantly from the treatment which should apply under an income tax. The rules have been complex (further complexity has been added as a result of transitional measures when the tax treatment was changed in the past - those rules are outlined in Appendix A4.1).

In general, compared to the income tax norm, superannuation and life insurance savings have been taxed on a preferential basis. In that way other savings vehicles have been placed at a competitive disadvantage. However, within the taxation regime applying to superannuation and life insurance there has been considerable diversity of treatment. Savings through personal lump sum superannuation schemes and life offices would usually have been taxed on a basis which approximates an income tax. Depending on the marginal tax rate of the scheme member or policy holder and the type of investments held by the scheme or life office, the taxation regime could be penal or preferential. On the other hand, savings through an employee pension scheme have, in many cases, received very large tax preferences with contributions being exempt, fund income being exempt, and a high proportion of benefits being paid out as tax-free lump sums.

A more consistent treatment of these forms of savings can be expected to give rise to a more efficient, fairer and simpler tax system. That can be achieved by moving these forms of savings on to a tax system which more closely approximates the income tax norm.

APPENDIX A4.1

SPECIAL TAX RULES FOR SUPERANNUATION AND LIFE INSURANCE

1 Introduction

This appendix considers the special tax rules which have applied to superannuation and life insurance. These rules are a product of past changes to the tax rules in this area. This appendix also outlines the tax position of non-approved superannuation schemes, that is, those schemes which have not received Government Actuary approval under the Superannuation Schemes Act.

2 Superanuation Contributions

As noted in Chapter 4, a member's superannuation contributions have been exempt income tax (up to the prescribed limits) if the scheme was an approved pension or a subsidised employee lump sum scheme. For other approved schemes (personal lump sum and non-subsidised employee lump sum), the exemption has applied only if the taxpayer was a member of the scheme on or before Budget night (8 November) 1984.

3 Annual Superannuation Fund Accumulations

Lump sum superannuation schemes, whether employee or personal, have been taxed on their net investment income since 1982. Prior to that such schemes were, like pension schemes, exempt tax on their net investment income. When the law in this area was changed, it was decided to retain the tax exemption for scheme funds in respect of those who were members of lump sum superannuation schemes prior to the 1982 Budget (5 August 1982). These funds have been known as Class A superannuation funds.

For <u>employee schemes</u> these funds are limited to:

a contributions made on or before 5 August 1982;

b Subsequent contributions to the extent that these do not exceed the amount set out in the Superannuation Schemes Act 1976. For a defined contribution scheme, this is in general the dollar amount of contributions made, on an annual basis, in the year ending 31 March 1983. For a scheme with a defined benefit obligation entered into on or before 5 August 1982, the set amount is generally the contributions which the Government Actuary considers appropriate to provide the level of promised benefits; and

c the annual accumulations of the Class A fund.

In the case of <u>personal lump sum schemes</u>, Class A funds consist of:

a contributions made on or before 31 March 1983;

b subsequent contributions to the fund to the extent that these do not exceed the greater of: the dollar amount paid on an annual basis in the year ending 5 August 1982, or the dollar amount paid in the year ending 5 August 1981; and

c the annual accumulations of the Class A fund.

Class A funds are not taxed on net investment income. The net investment income of all other lump sum funds (Class B funds) is taxable.

4 <u>Non-Approved Superannuation Schemes</u>

Superannuation schemes which have not received the approval of

the Government Actuary under the Superannuation Schemes Act 1976 have been taxed relatively penally. Member contributions have not been deductible to the member. Any employer contributions have have been non-deductible to the employer and subject to fringe benefit tax. The net investment income of such a fund has been assessable and the rate applying has been the company rate (48 cents in the dollar). Finally, the benefits of such a fund have been assessable if paid in pension form, but non-assessable if paid as a lump sum.

5 Life Insurance

The only special rule which has applied to life insurance has been that premiums have been deductible to the payer if the policy was a qualifiying policy entered into before Budget night 1984. The main requirements of a qualifying policy were that it had to:

- be taken out on the life of the taxpayer, or his/her spouse or children;
- pay benefits to the taxpayer, or his/her spouse or children;
- be a whole of life policy or have a minimum term of ten years; and
- pay a death benefit ascertainable from the policy.

APPENDIX A4.2

SUMMARY OF TAXATION PREFERENCES FOR SUPERANNUATION AND LIFE INSURANCE

This appendix summarises, in diagrammatic form, the tax preferences which have existed for superannuation and life insurance. Table A4.2.1 below presents a simplified version of those tax preferences. Contributions, annual fund accumulations and benefits are classified as either exempt or taxed. Exempt means that the financial flow is either deductible from the assessable income of the payer or not assessable in the hands of the payee. Taxed has the opposite meaning. For example, an employer's contribution to a superannuation scheme or life policy is said to be taxed if either the contribution is not allowed as a deduction from the employer's assessable income, or the contribution is taxed in the hands of employee, life insurance company or superannuation trustees. Differing marginal tax rates mean that equal income flows may not necessarily be subject to the same amount of tax even if both flows are labelled as taxed.

Table A4.2.1

	Contributions		Annual Fund	
	Individual	Employer	Accumulation	Benefits
<u>Superannuation</u>				
Employee				
Pension	Exempt	Exempt	Exempt	Taxed
Pre-82 lump sum	Exempt	Exempt	Exempt	Exempt
Post-82 lump sum	Exempt	Exempt	Taxed	Exempt
Personal				
Pension	Exempt	Exempt	Exempt	Taxed
Pre-82 lump sum	Exempt	Exempt	Exempt	Exempt
82-84 lump sum	Exempt	Exempt	Taxed	Exempt
Post-84 lump sum	Taxed	Taxed	Taxed	Exempt
Non-Approved				
Pension	Taxed	Taxed	Taxed	Taxed
Lump sum	Taxed	Taxed	Taxed	Exempt
<u>Life Insurance</u>				
Pension	Exempt	Exempt	Taxed	Taxed
Pre-84 lump sum	Exempt	Exempt	Taxed	Exempt
Post-84 lump sum	Taxed	Taxed	Taxed	Exempt
<u>Income Tax</u>				
<u>Norm</u>	Taxed	Taxed	Taxed	Exempt

CHAPTER 5 - WHY TAX PREFERENCES ARE BEING REMOVED

5.1 Introduction

As previous chapters have demonstrated, the past tax treatment of superannuation funds and life offices has been anomalous, not only as between themselves but also when compared with other savings institutions. Given the Government's decision to continue to levy direct taxation by way of income tax, any depature from normal income tax treatment needs to be justified.

In general, the more comprehensive any tax system is, the more likely it will meet the Government's tax reform objectives of efficiency, fairness and simplicity. This chapter outlines in more detail the arguments for a non-preferential tax regime for this aspect of the financial sector and this form of investment income. It is argued that past tax concessions have: been expensive in terms of tax revenue lost, created distortions in investment patterns and in employment behaviour, created the need for tight regulatory control of superannuation funds, led to tax planning, and have made the tax system unfair by favouring the high over the low income earner. Arguments for retaining tax preferences - the desirability of encouraging savings and the desirability of encouraging private, as opposed to public, provision for retirement - do not, in the end, stand up to close analysis.

5.2 Tax Privileges are Expensive in Terms of Tax Revenue Forgone

Tax privileges for superannuation and the premium exemption for pre-1984 life insurance policies significantly narrow the base from which income tax revenue is collected. If continued, it is estimated that the privileged tax position of superannuation funds and life insurance would (on the basis of the new tax rates announced on 10 February) cost the Government $660 million in tax reveneue forgone on a 1988/89 full year basis. Details are

provided in Appendix A5.1.

Removing those concessions will make the tax system more comprehensive and the extra tax revenue can be used to effect improvements to other aspects of the tax system. Thus, the extra revenue will be used to help pay for the reduced marginal tax rates announced on 10 February 1988. Those lower tax rates will reduce the extent to which the tax system discourages effort and savings.

5.3 Tax Privileges Distort Investment Behaviour

Taxation concessions for superannuation and life insurance are likely to have distorted investment patterns in a number of ways.

First, the concessions have encouraged people to save in a manner which they might not otherwise choose. For instance, they have encouraged people to purchase more life insurance or, in the case of superannuation, higher defined benefit annuities than they would in the absence of these tax preferences. Savings through superannuation or life insurance are also usually more difficult to access than, say, savings accumulated in a bank account. That lack of liquidity reduces the value of the savings to the saver. It means, for example, that people may not easily be able to use their savings to start, buy or expand a business when previously unforseen opportunities arise. In that way, the taxation privileges for superannuation and life insurance have been a penalty on small businesses.

Secondly, a more efficient financial sector should result from a

more even-handed tax treatment of different financial intermediaries. The concessions have diverted savings from other financial intermediaries to superannuation funds. Concessions on old insurance policies have provided incentives for people to continue these policies rather than use other financial intermediaries. Furthermore, people on high marginal tax rates have had an incentive to place funds in new life insurance policies to take advantage of the lower tax rate applying to fund income. All these tax-induced distortions have reduced the need for life offices and funds to provide services to borrowers and lenders at the lowest possible cost. In other words, because of their tax basis, the share of the financial market held by superannuation funds and life offices has not necessarily reflected their relative efficiency as financial intermediaries. The aim of having different financial intermediaries competing on an equal basis is especially important at a time when the Government has initiated a number of policy changes allowing more competition in the financial sector in order to promote efficiency and a better service to consumers. The removal of the privileges enjoyed by superannuation funds and life offices will increase competition and enhance the Government's broader policies.

As well as possibly causing inefficient financial intermediation, tax preferences may have encouraged unnecessary intermediation. They are likely to have encouraged people to use superannuation funds and life offices as investment intermediaries when they might, in the absence of tax concessions, have preferred to invest directly.

By channelling savings through superannuation funds and life offices, the tax preferences will have created further economic costs if funds and offices have had different investment preferences from alternative intermediaries or from the savers themselves. That will have distorted the allocation of resources within the economy.

There has been some evidence that investment has been distorted in that way. In a book published by the New Zealand Institute of Policy Studies in 1985, How Should Business be Taxed?, Mr Paul Bevin concluded that tax preferences in this area have probably "significantly affected the pattern of investment in New Zealand, contributing to concentration of investment in larger established businesses, rather than smaller growing firms." One reason for this is that superannuation funds and life offices, because of the long-term and certain nature of their liabilities, tend to have a preference for long-term, relatively low-risk investments. Some overseas studies have suggested that superannuation schemes and life offices investing on the share market have concentrated on relatively large companies, channelling funds away from smaller companies, so reducing the economy's flexibility and the amount of competition. These findings cannot be considered conclusive, however, because of the difficulty of determining how people would invest their savings in the absence of superannuation schemes or life offices.

A less ambiguous investment distortion has been caused by the tax-exempt status of pension funds. Tax-exempt institutions (such as pension funds) lose part of their taxation advantage if they invest in companies by purchasing shares. On the other hand, they retain their tax advantage if they lend to companies or to other entities such as the Government. The tax system has thus not only encouraged savings to be placed in pension superannuation schemes, but has then encouraged those schemes to lend money rather than invest in the corporate sector as equity participants.

To understand this effect more clearly, the December 1987 Consultative Document on Full Imputation demonstrated that, under the company tax system which taxes companies as they derive income and shareholders on distribution of dividends, the effective tax rate on investment depends on whether the

investment is financed by debt, retained earnings or new equity. Its conclusion was:

a the effective tax rate on corporate investment financed by debt is the effective rate of the lender;

b the effective tax rate on corporate investment financed by retained earnings is the effective company tax rate; and

c the effective tax rate on corporate investment financed by new equity exceeds the effective company tax rate, but decreases towards that rate the longer the income is retained in a company.

Since tax-exempt superannuation funds effectively have a zero tax rate, equity investment by such funds results in a tax penalty. Their return on debt instruments is tax-free, but earnings on equity investments are taxed at the effective company rate. That penalty may be borne by the company raising funds. In such a case the company has to generate sufficient income (after payment of company tax) to produce the rate of return required by the superannuation fund (i.e. the same return as could be received from an equivalent debt investment).

The full imputation system is being introduced so as to remove such distortions between different forms of company finance. However, as in Australia, it has been found necessary to deny imputation credits to non-taxpayers. This means that income tax will be paid by the company despite the tax-exempt status of the equity owner. If pension superannuation funds were to retain their exempt status, earnings on their share investments would still be taxed at the effective company tax rate. Tax-induced investment distortions in this area would continue to arise and a significant part of the benefits of imputation would be lost.

A further possible investment distortion caused by superannuation tax privileges is a product of the influence company management often has over the superannuation scheme established for the benefit of employees. In many cases that scheme will build up considerable financial resources as a result of employees being induced by the tax system to save through the scheme. It is often possible for the scheme to use some of those savings for investment in the contributing firm by way of shares. That shareholding may then be used by the firm's management as a means of warding off unwelcome takeovers. Since takeovers are one of the methods by which the economy's resources are allocated to their best use, the end result can be lower overall economic performance.

5.4 Tax Privileges Distort Employment Contracts

As well as distorting investment patterns, tax concessions in this area are likely to have distorted aspects of employment contracts.

Employer-paid superannuation contributions and life insurance premiums form part of the remuneration packages of employees. Because of tax preferences, people are induced to receive a higher proportion of their remuneration in this form when, in the absence of tax concessions, they might prefer to receive more of their income in cash and thus be free to make their own decisions on investment and consumption. This argument for removing the concessions is the same as the argument for taxing other forms of remuneration received as fringe benefits.

Employee superannuation appears to have created particular distortions in labour contracts. It is often argued that tax concessions for employee superannuation impede labour mobility. The argument is that the concessions increase superannuation contributions and therefore increase the loss to an employee on early withdrawal from a scheme with limited vesting. However the

effect of the present tax concessions on labour mobility is less than clear cut.

While the tax concessions lead employees to weight their remuneration packages toward superannuation, they should not overly affect the _type_ of superannuation or the degree of vesting (ie the extent to which benefits are independent of length of service). In general, the degree of vesting can be expected to be determined by the requirements of an efficient employment contract. That may involve some form of limited vesting of employer superannuation contributions to compensate employers who have provided training to a staff member who leaves for another job. This is similar to the role of severance or redundancy payments which act as a form of insurance for an employee against loss of his or her investment in learning skills specific to a particular job.

However, as explained in the previous chapter, employees can receive significant tax advantages by leaving their job, withdrawing from the superannuation scheme and taking their superannuation rights as a tax-free lump sum. To offset the tax incentive for employees to change jobs, employers can be expected to have provided superannuation in a form which restricts labour mobility by limiting vesting.

The end result of the tax concessions is that employees receive more of their remuneration in the form of superannuation than they would in the absence of the tax concessions. That can in turn create incentives for employees to change jobs. To prevent labour turnover increasing, employers provide superannuation in a form which limits vesting to a greater extent that the underlying employment relationship justifies. Thus laws in this area have caused remuneration to be provided in a less than optimal form with more complex remuneration packages and greater restrictions on job mobility than would otherwise be justified. Two leading British tax commentators have concluded that specific tax

concessions for superannuation disadvantage employees. Whereas money in the bank increases an individual's ability to disagree with his or her employer; wealth in the form of accrued pension rights reduces it. (Kay and King The British Tax System, 1983)

5.5 Tax Privileges Make Regulatory Controls Necessary

The economic costs of the tax privileges are partly the product of the various statutory and regulatory controls on superannuation and life insurance. Particularly for superannuation, many of these controls are a consequence of the tax concessions. For example, a superannuation scheme member cannot easily gain access to his or her superannuation savings because this is generally prohibited by restrictions imposed by law. One of the main purposes of such restrictions is to limit the scope and cost of the tax preferences. If superannuation savings were easily accessible, bank accounts could be transformed into superannuation funds and receive their tax privileges. Similarly, existing regulations prevent superannuation schemes from using funds in a business. Again this is partly to prevent businesses from forming themselves into superannuation funds in order to access tax concessions. One consequence of the regulatory restrictions placed on the substantial funds held by superannuation schemes is that the funds are not available for a number of purposes including the financing of small businesses.

For life insurance, past tax concessions made it necessary to have regulatory restrictions which distinguish life offices from other financial institutions. The present basis of taxation of life insurance makes it necessary to retain this distinction.

This regulatory ring-fencing of life insurance is becoming more difficult. As the financial sector develops in a less regulated, more competitive environment, the traditional distinctions between types of financial institution and the services they

provide are becoming blurred. Trading banks are now offering the services once the preserve of life offices and vice versa. Not only have the lines between different institutions become blurred, but the services which are being marketed are also becoming less differentiated. An example is the incorporation of a separate savings instrument in a life insurance plan (unbundled life policies)and the sale of "savings bonds" by life offices.

As the boundary lines between different financial institutions and their services fade, differences in tax treatment become sustainable only by erecting a more and more elaborate and arbitrary system of fencing. Extension of the regulatory regime in that way could further restrict the ability of those affected to provide the services consumers want and would thus be likely to lead to an increase in the efficiency costs associated with these tax concessions.

5.6 Tax Privileges Give Rise to Tax Planning

The existing regulatory controls in New Zealand have failed to restrict access to the tax privileges in the way intended. Some examples of methods used to gain tax advantages under the present regime are:

a the incorporation of short-term debt instruments (life bonds) and investment programmes (unbundled life policies) under the life insurance umbrella;

b personal lump sum superanuation schemes aimed at the more affluent 60-plus age group who have no restrictions on tax-exempt withdrawals. The scheme can be operated in a similar manner to a bank account but interest is taxed within the scheme at the lower scheme tax rate;

c employee schemes structured so as to divert most of the tax benefits to a few key employees;

d employee pension schemes structured so as to allow them to be wound up with benefits distributed to members as tax-free lump sums;

e employee schemes used in artificial employment situations; and

f employee pension schemes using borrowings from members to take greater advantage of the concessions.

Another opportunity has been exploited overseas. Many defined benefit plans have moved to a position in which their existing level of funds exceed their liabilities under the plan. Overseas some companies have attempted to access this surplus by clawing back past contributions. These developments are most advanced in the United States of America where schemes (which are often solely employer-funded) have been wound up and excess funds returned to the employer company. In one case the amount recaptured in this way has been reported as amounting to $1 billion.

In New Zealand an employer can recapture excess funds in a scheme which is wound up if this is provided for in the trust deed and approved by the Government Actuary. Many schemes have such a trust deed provision. Opportunities thus exist for employers to receive the tax benefits intended for employees, especially if the excess funds can be returned to employers tax-free.

Another possible avenue of tax planning is the arbitrage opportunities which a tax-exempt pension fund can provide. For example, a taxpayer can sell an income earning asset to a pension fund. The pension fund then derives the income tax-free while the taxpayer derives a tax-free capital gain.

The exploitation of tax preferences in order to reduce tax liabilities erodes the tax base and makes the tax system appear

unfair. Arbitrage opportunities are difficult to counter so long as taxpayers are on significantly different tax rates. Moves to reduce the variability of tax rates and to tax different entities and activities in a more uniform manner are the only effective means of dealing with such problems.

Other tax opportunites could be reduced by implementing a more stringent regulatory regime. However, more stringent regulations would be likely to increase the economic costs of the regime and may not be successful in preventing the preferences being used in unintended ways. The level of regulatory complexity and stringency applying to United States' superannuation schemes seems indicative of the approach New Zealand would have to adopt if the preferences for this form of saving were maintained. Examples of the rules applying in the United States are: maximum contribution levels, maximum and minimum benefit levels, minimum vesting rules, strict rules as to allowable investments, and provisions which require employers to ensure that the benefits of the plan are provided across all levels of employees taking into account voluntary employee contributions as well as employer contributions.

5.7 Tax Privileges Make the Tax System Unfair

As well as providing tax planning opportunities, tax privileges for superannuation and life insurance have created perceived inequities in the tax system. New Zealand and overseas (American, Canadian, and Australian) data are consistent in finding that tax concessions for this form of saving favour the following groups.

a High Over Low Income Earners

Higher income earners are in a better position to make the most use of these taxation concessions for a number of reasons. Firstly, they have the ability to save a larger

percentage of their income which is then available to be saved in a superannuation scheme. Secondly, under a progressive income tax structure, the concessions provide a greater benefit to high- as compared to low-income earners. Third, those with high marginal tax rates have been able to benefit from the relatively low rate of tax applied to life office income. Finally, high income earners are generally better able to take advantage of the various tax planning opportunities which the rules have made available.

This is confirmed by data extracted from the Household Expenditure and Income Survey. On the basis of this data, it is estimated that in 1988/89 48 per cent of superannuation contributions and life insurance premiums will be paid by individuals with incomes over $31,000. The proportion of fund earnings attributable to this group is likely to be significantly higher. This is because a larger share of fund earnings are likely to be attributable to older scheme investors who can be expected to have incomes higher that the average for the fund.

It is also estimated that people on or below the average income (for all those aged 15 or over) have been receiving only about 5 per cent of the tax benefits from the superannuation contribution deduction. This means that 95 per cent of the benefits of the tax concession has been going to those with above average incomes. People on twice the average income and upwards have been receiving over half the benefits the concession provides. For every dollar of concession delivered to people on the average income, $16 was being delivered to people on incomes three times higher than that average. Moreover, these figures do not take into account the likely additional skewing of the system in favour of the wealthy which could be expected to occur as a result of employer contributions also favouring the rich.

Further details on how the concessions have been favouring the higher income earner are provided in Appendix A5.2.

b Employees Over the Self-Employed

New Zealand tax rules have favoured employee schemes over personal schemes. Member contributions to a personal lump sum scheme have not been deductible, whereas contributions to an employee lump sum scheme have been. Employee schemes have also benefited from tax-exempt employer contributions, an advantage which personal schemes are not compensated for by the higher exemption level for member contributions. Thirdly, the benefits of an employee pension scheme are easier to access as a tax-free lump sum than the benefits of a personal pension scheme.

These differences in treatment, together with the restrictions imposed on substantial shareholders from joining a firm's employee superannuation scheme, discriminate against the self-employed and those who have put their own money into a firm. Moreover, many self-employed provide for their retirement by investing their capital in their business or farm. Such investments do not qualify for the concessionary treatment afforded superannuation.

c Those Employed by a Single or Few Employers Over those who Change Employers Relatively Frequently

The design of most employee superannuation schemes provides limited vesting of employer contributions and net investment earnings. This means that those who change employers or spend periods out of regular employment can receive limited advantage from superannuation tax preferences. Instead, the main beneficiaries tend to be those who have an uninterrupted career with the one employer. This has tended to favour public servants and

employees of large private sector firms.

d Those with a Relatively Stable Lifetime Income Over those with a Fluctuating Income

Annual limits on exempt contributions disadvantage those who have irregular incomes or spend periods out of the workforce, for instance, receiving an education. Such people often cannot benefit from even the more limited preferences available to personal schemes since they may have little or no assessable income to offset with contributions.

e Those in Full-time Employment over Those Working Part-time

While this is not necessarily the case, occupational superannuation schemes are often limited to full-time staff.

Women tend to figure disproportionately in all the above disfavoured groups and thus tend to receive minimal advantages from the tax concessions. Women tend to be lower income earners, are less likely to maintain a career outside the home, are more likely to change jobs and work part-time, and often interrupt or permanently cease income-earning activity in order to raise children. They therefore tend to be poorly covered by superannuation. Data from the Household Expenditure and Income Survey for 1985/86 suggest that only about 23 per cent of those making contributions to superannuation schemes in that year were women.

5.8 The Need to Increase Savings

It has been argued that superannuation and life insurance tax privileges are justified because incentives are required to encourage savings, especially long-term savings, in order to

foster economic growth.

This savings argument lacks substance.

From an economic perspective there is nothing inherently good (or bad) about savings, any more than there is anything inherently bad (or good) about consumption. In general, people can be expected to make consumption and savings choices in a way which, given constraints which the Government imposes, maximises their welfare over time. In the absence of other considerations, no government intervention to alter the level or rate of savings is called for. The appropriate role for the government is to enable welfare to be maximised. Subject to the Government's redistributive goals, this can best be achieved by creating an environment in which resources are efficiently allocated to maximise output. It is not necessarily achieved by instituting policies which attempt to induce people to defer consumption (ie to save).

The available evidence does not suggest that New Zealand's past poor economic performance is the result of a paucity of savings. Instead it has been the result of the inefficient allocation of resources. Our savings to Gross Domestic Product ratio has been about average for OECD countries yet our growth rate has been markedly below average.

There are at least two areas where government action can distort decisions which determine the economy's overall level of saving. First, by running Budget deficits which it does not finance from domestic sources, it may signficantly reduce the net overall level of savings. Secondly, as discussed in Chapter 3, the income tax system inherently imposes a tax penalty on savings. Both of these concerns have been met directly by the Government's actions to bring the deficit under control and to fund it appropriately, and by the measures it has already taken to reduce income tax rates.

Even if the Government did wish to increase the rate of private savings, there is no obvious reason why it should do so by favouring superannuation and life insurance over other forms of saving. Moreover, while it is clear that the penalty which income tax imposes on savings results in a significant economic cost, it is less clear that taxation concessions to increase the after-tax return on savings necessarily lead to an increased rate or level of savings. While on the one hand an increased after-tax return from savings increases the relative incentive to save, on the other hand it results in those who have some savings target (such as an adequate level of retirement income) having to save at a lower rate in order to meet that target. Where the balance lies is difficult to assess with the economic evidence being inconclusive.

What is clear is that taxation concessions for particular forms of saving do influence the allocation of savings among different institutions and that this is likely to incur economic costs. The announced tax rate reductions and other taxation reforms, combined with the Government's budgetary policy, are far more likely to produce a more appropriate savings response than the maintenance or granting of special taxation privileges to selected financial intermediaries.

5.9 The Need to Support Long-term Savings

There is no particular reason why the Government should favour long-term savings over shorter-term savings. Borrowers' requirements for longer-term savings will be reflected in differences in the interest rates which are offered for various terms. There is no reason why the Government should intervene and impose its own asssessment of the relative merits of short- versus long-term savings or investment. In addition it is one of the functions of financial intermediaries to transform a flow of short-term savings into longer-term loans. Thus, there is no need for long-term investment projects to necessarily be financed

by long-term savings. The share market is, perhaps, the best illustration of this point.

The need to provide some special encouragement for long-term finance was carefully considered by the 1981 (Campbell) Committee of Inquiry into the Australian Financial System. It recommended the removal of the taxation exemption for superannuation fund net investment income. It concluded that should the Government choose to pursue a policy of greater neutrality between various forms of saving, this would not necessarily mean a reduced overall supply of long-term capital. It saw "no basis for concern about future shortages of long-term capital provided the financial system is not shackled by too many restrictions", and saw "no justification for government intervention on the basis of spurious or at best uncertain projections of future supply and demand for capital".

The Committee's basic recommendations were that the Government should remove unnecessary restraints it had imposed on the financial sector. In the absence of those constraints the financial sector was able to meet the capital requirements of the economy without the need for special tax concessions. The New Zealand Government has freed up the financial sector in a way which should allow that sector to respond to the requirements of the rest of the economy.

5.10 The Need to Encourage Private Provision for Retirement

It has also been argued that tax expenditures in the form of privileges to superannuation and life insurance meet an important social goal - the encouragement of private provision for old age.

The argument that these tax concessions are necessary to help alleviate poverty amongst the aged is invalid for a number of reasons. First, there are strong private incentives to provide an acceptable standard of living during one's retirement.

Secondly, the Government already provides relatively generous retirement support in the form of national superannuation. Thirdly, this form of tax expenditure is an inefficient method of assisting the elderly. The tax preferences are not targeted to those who might be most in need of government assistance. Furthermore superannuation covers only a minority of the population. Of the total labour force, only some 26 per cent belong to employee superannuation schemes (20 per cent to employee pension schemes, and 6 per cent to employee lump sum schemes). Moreover, many who belong to employee pension schemes receive relatively low retirement benefits through, for example, changing jobs. (It has been estimated in Canada that fewer than 10 per cent of members of pension plans end up with a full pension).

It was these sorts of reasons which led the Canadian National Council of Welfare to conclude that tax incentives for superannuation "turn logic and equity upside down, favouring those who need help least and driving an additional wedge between the incomes of the have and have-not elderly" (April 1984 Report on the Retirement Income System). Similarly, in Australia, an April 1984 Department of Social Security research paper, Government Support of Retirement Incomes in Australia, concluded that, despite the considerable cost to the government of tax concessions for occupational superannuation, benefits from such schemes "are received by relatively few aged people and generally provide a modest supplement to, rather than replace, the age pension."

It is commonly argued that tax concessions for superannuation are a means of reducing the government's future pension liabilities. With the introduction of the National Superannuitant Surcharge, this argument has some validity. However, this benefit has to be weighed against the present day costs the concessions incur, both in revenue and economic terms. All the available evidence suggests that in return there is minimal coverage which is

concentrated on those who are likely to need future retirement income support least. In short, as a welfare measure, the concessions fail any reasonable cost-benefit analysis.

It should be noted that the future role of the Government in providing direct income support for the elderly is outside the scope of this tax reform exercise. This issue is being considered by the Royal Commission on Social Policy.

5.11 Conclusion

Taxation privileges for superannuation and life insurance are inequitable and incur high economic costs. Any of the supposed benefits which the concessions provide in terms of increased incentives to save and higher retirement incomes are better met by more direct policies. These are likely to be far less costly in revenue and economic terms as they can be designed to target those most in need.

It has therefore been decided to move superannuation and life insurance onto a normal income tax treatment. As far as possible they should be treated on the same basis as other financial investment vehicles. Broadly this involves:

a taxing contributions and life insurance premiums at a rate as close as possible to the marginal tax rate of scheme members and policyholders;

b taxing the net investment income of funds and life offices at a rate as close as possible to the marginal tax rate of scheme members and policyholders; and

c exempting all superannuation and life insurance benefits from taxation.

As far as possible, regulatory restrictions on superannuation

schemes and life offices, other than those which are necessary or desirable to protect investors, should be removed. The taxation and regulatory regime will, as far as possible, not discriminate between schemes and life insurance which provide lump sum benefits and those which provide pension benefits. Indeed, it would be desirable to allow schemes and policies to permit, if they so wished, switching between lump sum and pension benefits.

APPENDIX A5.1

TAX REVENUE FORGONE AS A RESULT OF TAX PRIVILEGES FOR SUPERANNUATION AND LIFE INSURANCE

This appendix details estimates of likely tax revenue forgone if tax privileges for superannuation and life insurance were continued into 1988/89. The estimates are given assuming the new tax rates announced on 10 February 1988. The estimates are also on a full year basis. This is not an estimate of the additional tax revenue resulting from the tax changes outlined in this document.

The figures are arrived at by estimating the revenue which would be raised if savings through superannuation and life insurance were taxed on a normal income tax basis. This is the same basis on which the Treasury of the United States of America calculates its published estimate of tax expenditures incurred by the Federal Government as a result of similar tax concessions.

Table A5.1 Tax Revenue Forgone as a Result of Tax Privileges for Superannuation and Life Insurance, in 1988/89 Terms

	$ million
Superannuation	
Exemption for member contributions	130
Exemption for employer contributions	290
Exemption for net investment income	260
Gross revenue forgone	680
Minus tax on pensions (excluding surcharge)	(110)
Net revenue forgone	570
Life Insurance	
Premium exemption	105
High tax rate on net investment income	(15)
Net revenue forgone	90
Total Net Revenue Forgone	660

APPENDIX A5.2

DISTRIBUTION OF TAX BENEFITS RECEIVED FROM THE PERSONAL SUPERANNUATION CONTRIBUTION EXEMPTION

The following data was extracted from the Household Expenditure and Income Survey. It reflects tax benefits for different income levels with respect to superannuation contributions in the 1986/87 financial year. The survey covers all individuals, whether or not they are members of the labour force, aged 15 years or over.

It is assumed that all superannuation contributions, up to a maximum of $1,400 per annum qualify for the exemption. That may lead to average benefits being over-stated to some extent because, for a person who is a member of a subsidised employee superannuation scheme, the maximum exemption has been $1,200. On the other hand, many of the lower income earners are likely to be members of higher income households. Moreover the data probably understates the extent to which the well-off receive the benefits of the overall superannuation concessions since the well-off are more likely to receive high employer contributions and are more likely to have large sums accumlated in superannuation schemes.

Column 1 shows assessable income bands. The estimated average assessable income for the surveyed population in 1986/87 was $15,131.

Column 2 is the estimated average annual tax benefit received by those who contribute to a superannuation scheme within the indicated income bands.

Column 3 states the percentage of the overall benefit claimed by all eligible individuals which is received by individuals within that income band.

Column 4 gives the ratio of the percentage of the benefit claimed to the percentage of individuals within the income band. Thus, if the percentage of the benefit received is the same as the percentage of the population, then the ratio is 1. If the percentage of the benefit received is twice the percentage of the population, the ratio is 2.

Column 5 lists the cumulative percentage of the benefit received by each income group beginning with the highest income group.

Table A5.2 Distribution of Tax Benefits form the Personal Superannuation Contribution Exemption

income	average annual benefit	share of total benefit	share relative to number in band	cumulative share from highest to lowest band
(1)	(2)	(3)	(4)	(5)
$	$	%		%
<5000	119	0.4	0.02	100.0
5000-9500	109	0.5	0.03	99.6
9500-14000	206	2.2	0.18	99.1
14000-16000	233	2.3	0.37	96.9
16000-18000	274	4.6	0.82	94.6
18000-20000	289	5.0	0.91	90.0
20000-22000	292	6.4	1.31	85.0
22000-25000	316	9.3	1.69	78.6
25000-30000	379	17.6	2.71	69.3
30000-40000	527	33.6	4.73	51.7
40000-50000	596	13.1	6.24	18.1
50000+	594	5.0	3.33	5.0

CHAPTER 6 - HOW SUPERANNUATION AND LIFE INSURANCE SAVINGS ARE TO BE TAXED

6.1 Introduction

For the reasons given in Chapter 5, the preferential tax treatment of superannuation cannot be justified on economic or social grounds. Thus, the Government has decided to move the tax regime from that described in Chapter 4 to a regime which more closely approximates normal income tax treatment as outlined in Chapter 3. This chapter provides further details on how the proposed and announced measures will operate for both superannuation and life insurance. Chapter 7 considers transitonal issues and implementation dates.

6.2 Registration of Superannuation Schemes

There are a number of practical difficulties with applying an income tax system to superannuation. Administrative considerations require taxation rules which are, to some extent, special. To make these rules workable it will be necessary to identify superannuation schemes to which the special tax rules apply.

This can be done by requiring such schemes to be registered with the Government Actuary or the Inland Revenue Department. Such schemes will be referred to as "registered superannuation schemes". It should be noted that the requirement for registration does not, of itself, imply any particular form of regulation of such schemes. Regulation of superannuation is considered later in this chapter. In broad terms a "registered superannuation scheme" will be a scheme or fund established principally for the purpose of pooling contributions made by individuals as members and/or their employers and which uses those funds principally to provide retirement or similar benefits to those members or their dependents or survivors.

Unfunded superannuation schemes will not qualify for registration. Under an unfunded scheme no contributions are paid in advance to meet the scheme's future liabilities in terms of promised benefits. Examples of unfunded schemes include some overseas employee schemes where employers provide superannuation by promising retirement benefits provided certain conditions, such as length of service, are met. However, retirement benefits are paid directly to the recipient by the employer and no fund separate from the employer is established. Accordingly, there is no identifiable fund earning investment income on which tax, calculated in accordance with the superannuation tax rules, could be levied.

A superannuation scheme is partly-funded when employee and/or employer contributions are sufficient to meet only part of the scheme's future benefit liabilities. Such schemes will be able to be registered (subject to meeting other registration criteria) to the extent that the scheme is funded.

6.3 Member Contributions to Superannuation Schemes

The deduction which has been available for member contributions to superannuation schemes is being withdrawn. People saving in this manner will, as with bank account deposits, not receive any tax deduction for the savings they make and will thus make those savings out of after-tax income.

6.4 Deducibility of Employer Contributions to Superannuation Schemes

In general, employer contributions to a superannuation scheme of any type or category will be fully deductible from the employer's assessable income provided that the normal test requiring a nexus or connection between the expenditure and the gaining of assessable income is established. Since superannuation contributions for the benefit of employees forms part of a firm's

labour costs, there should normally be little difficulty in establishing the required connection with an assessable income earning process.

The removal of tax concessions for superannuation would result in superannuation contributions being taxed on the same basis as other forms of remuneration. There should then be no reason to impose constraints on the employer's ability to deduct this particular form of remuneration.

The restrictions currently imposed by section 150 of the Income Tax Act on the deductibility of employer superannuation contributions, in respect of:

a the quantum of total contributions which are deductible; and

b contributions to a personal superannuation scheme;

should therefore be removed.

The absolute discretion vested in the Commissioner of Inland Revenue by section 150(6) of the Act allowing him to deny a deduction for any employer superannuation contribution in whole or in part should also be removed.

The provision in section 150(7) of the Act which denies a deduction for employer contributions which are refunded or repaid to the employer are aimed at clawbacks of employer contributions. It has not been clear how this applied where the clawback included surplus investment earnings of the fund. Moreover, the provision could be relatively easily circumvented. Provided the contributions are taxed when initially paid, and provided earnings of the scheme are appropriately taxed, there is no need to retain this provision.

Section 150(4) of the Act provides the Commissioner with a discretion to deny a deduction in respect of contributions paid by any company in respect of any employee who has a 20 per cent or more interest in the employing company. As noted in Chapter 4, this provision can interact with section 4(2) of the Act so that such contributions can be deemed to be a dividend. The preferred approach is to remove this restriction on the deductibility of shareholder-employee superannuation contributions. However, this raises questions of how proprietary company dividends and major shareholder-employees are to be treated generally; an issue raised by the Consultative Document on Full Imputation which is being considered by that Consultative Committee. The Consultative Committee on Superannuation and Life Insurance will consider the need to retain section 150(4) in the light of the Government's decisions on the general tax treatment of proprietary dividends and major shareholder employees.

The deductibility of superannuation contributions will be restricted to contributions to registered superannuation schemes. That is to preserve the existing position where contributions to non-approved schemes are non-deductible.

It will also be necessary to prevent firms from deducting liabilities they may incur by assuming superannuation obligations under an unfunded superannuation scheme. Where no employer payments are made, but the employer agrees to provide future superannuation benefits, there are practical difficulties in imposing a current tax liability on such promised benefits. To provide a tax deduction for the employer without an offsetting tax on the employee remuneration, would produce similar taxation advantages as are now available for actual contributions. In the absence of any ability to tax the benefits accruing to employees, employer deductions will be denied. This will result in such benefits effectively being taxed at the employer's marginal tax rate.

In some cases the management and administration expenses of a superannuation scheme are incurred by the scheme's trustees. Those expenses may be met out of the employer contributions. For other schemes, generally those operated for employees of larger firms, scheme management and administration expenses are met directly by the employer. Such expenses have generally been deductible under existing law. No change in this position is proposed.

6.5 Taxation of Employer Contributions to Superannuation Schemes

If employer superannuation contributions are to be treated as part of an employee's remuneration package, they should be taxed at a rate as close as possible to the tax rate of the scheme members.

Tax Options

There are at least three possible options for meeting this objective:

a Tax each scheme member on their share of employer contributions. There are a number of problems with this approach. First, it would result in employees incurring a tax liability on income which they have not received in cash causing possible cash-flow difficulties. It is desirable to avoid such difficulties where possible, especially with respect to individuals who usually operate on a cash basis. Secondly, taxing employees on that part of employer contributions which did not automatically vest with him or her, could result in those who lose non-vested superannuation contributions (as a result of changing jobs for example), paying tax on income which they will never receive. The contributions representing non-vested rights would instead be left in the fund and eventually distributed

to remaining scheme members or would be returned to the employer by way of reduced employer contributions or clawback. On the other hand, if tax were not levied until employer contributions vested, the superanuation tax privileges would be effectively replicated. This option has therefore been rejected.

b Tax the scheme itself on contributions it receives. Under this option contributions would be taxed at the marginal tax rate of the scheme.

c Subject contributions to fringe benefit tax. This option taxes the employer as a proxy for the scheme members.

The viable options are to tax the scheme or to remove the fringe benefit tax exemption which employer superannuation contributions currently enjoy. The fringe benefit tax option has been chosen on the basis that it is likely to incur the lower administrative and compliance costs.

Employee and Personal Schemes

It would seem desirable to avoid having to distinguish between employee and personal superannuation schemes. Thus employer contributions to either an employee or a personal scheme will be subject to fringe benefit tax and will be excluded from employee remuneration. The position of shareholder-employees will be reviewed in the light of the Government's decision on how such taxpayers should be taxed generally once the imputation system is in place.

What is to be Taxed

The fringe benefit tax liability will attach to any payment made by the employer to a superannuation fund for the benefit of an employee. Thus, it will not include promises to provide future

benefits under an unfunded scheme. It will, however, include payments to a scheme to meet scheme management and administrative expenses. Where those expenses are met directly by the employer, that will constitute a taxable fringe benefit being a benefit consisting of a service indirectly enjoyed or received by the employee.

Tax Rate

Fringe benefit tax is a non-deductible expense. The fringe benefit tax rate is calculated so as to reflect this. The formula on which the present fringe benefit tax rate is set is:

$$[P/(1-P)] \times (1-C)$$

where P is the personal or employee tax rate;
and C is the company or employer tax rate.

The value of the fringe benefit in the hands of the employee is grossed up to its pre-tax value (achieved by dividing by (1-P)). This grossed-up value is taxed at the personal tax rate. The resulting rate is then adjusted (by multiplying by (1-C)) to take account of the non-deductibility of the tax to the employer.

The personal tax rate used to calculate the fringe benefit tax rate is the top personal marginal rate of tax. However, as a transitional measure, lower rates will be applied to previously exempt employer contributions made in 1987/88 and 1988/89. These rates are given in Chapter 7.

6.6 Taxation of Net Investment Income of Superannuation Schemes

It was announced in the 17 December Statement that the earnings of superannuation schemes would be taxed along the same lines as

have applied to life offices and those superannuation schemes which have been subject to tax in the past. These are Category 2 schemes (Class B or post-1982 lump sum schemes) and Category 3 schemes (schemes not approved by the Government Actuary).

As explained in Chapter 4, Class B funds and life offices are taxed as a proxy for scheme members and policyholders. It is a more practical, albeit indirect, alternative to taxing scheme members and policyholders on the income which the fund or life office earns by investing their savings. It is proposed to adopt this approach for all superannuation funds.

Taxable Revenue

Included in the taxable income of a superannuation scheme will be all revenue derived by the scheme from its investments, including dividends received. As with existing taxable superannuation schemes, contributions will not be assessable in the hands of the scheme. Income derived from life insurance policies held by the scheme will also be non-assessable. The proceeds of the policy would be non-assessable in the hands of an individual and will have already borne tax at the life office level.

An important question is the extent to which superannuation schemes should be taxed on any gains made on investments which, if made as the result of the direct investment of the individual, would not be subject to income tax on the basis that the gain is of a capital nature. Under existing law, taxable superannuation schemes (in a similar manner to life offices) are taxed on any gain made on the realisation of an investment by way of sale. Investment losses by way of sale are deductible.

A primary objective of the taxation reforms in this area is to tax, as far as possible, investments through different intermediaries in the same manner. Tax rules which effectively favoured superannuation schemes would be contrary to this

objective. It is therefore proposed that superannuation schemes be taxed on investments in the same manner as banks, life offices and currently taxable superannuation schemes. This treatment is also consistent with that proposed under the imputation system for unit trusts, whereby dividends paid out of capital profits will remain assessable. Thus superannation schemes will include in assessable income any profit or loss from the disposal of any of the scheme's investments. Superannuation schemes will also be subject to the accrual rules in sections 64B to 64M of the Income Tax Act (and for the purpose of certain de minimus provisions such as that governing cash basis holders of financial arrangements, superannuation schemes will not be deemed to be natural persons).

Deductible Expenditure

Expenses incurred in deriving investment revenue will be deductible. No deduction will be available for benefits which the scheme pays out. Some other expenses which a scheme is likely to incur will not be deductible. This includes expenses incurred in the development, marketing, selling, promoting and advertising of the scheme. Administration and management expenses will be deductible so far as they relate to the scheme's investment activities, but non-deductible so far as they relate to the costs of obtaining and administering contributions.

One justification for denying deductions for expenses incurred in raising and administering contributions is that contributions will not form part of the superannuation fund's assessable income. However, even if superannuation funds were to be taxed on contributions, as a proxy for individual members, contribution-raising and administration expenses should still be non-deductible. First, superannuation contributions can be interpreted as a form of equity investment by members. Each member is taking an ownership share in the enterprise. Equity-raising costs are of a capital nature and therefore should be

non-deductible. Secondly, under the net investment income approach, superannuation funds are untaxed on any profit made from any risk-pooling or insurance activity. Contribution-raising and administration costs can be seen as a cost of this risk-pooling activity. Since the activity will be tax-exempt, costs associated with it should be non-deductible.

The existing rules for the taxation of Class B lump sum schemes provides that no deduction from investment revenue is allowed for expenditure which is recoverable from any contributor. That provision has caused interpretive problems since most costs can be said to be, directly or indirectly, met out of funds provided by contributors. There seems to be little justification in limiting deductible expenditure on the basis of whether or not contributions were specifically earmarked for particular purposes. Presumably, the restriction was inserted because of concern that otherwise participating employers could receive a deduction for their contributions, those contributions were untaxed, and the scheme could receive a further deduction when the contributions were used to meet investment costs. Since employer contributions will now be subject to taxation, in the form of fringe benefit tax, this concern no longer applies. Provided that the costs are incurred in deriving assessable income of the scheme, they should be deductible.

Some costs of the scheme will be partly attributable to the deriving of investment revenue and partly attributable to scheme adminstration, promotion etc. Such costs will need to be apportioned. The method of apportioning used under the existing taxation regime for life offices is on the basis of the ratio of premium to gross revenue of the office. The premium proportion so determined is non-deductible. Using this rule, apportionment for superannuation schemes would be on the basis of the ratio of contributions to gross revenue. However, the proportion of a scheme's gross revenue consisting of contributions is likely to be a poor approximation of the proportion of its expenses which

are attributable to non-deductible costs. It seems preferable to apportion such costs on a basis which, in each case, is acceptable to the Commissioner of Inland Revenue.

Rate of Tax on Net Investment Income

The approach adopted in the past for taxable lump sum superannuation funds has been to levy tax on net investment income of the fund at a flat rate which has been intended to approximate the average marginal rate of scheme members. The rate applying in 1987/88 for Class B lump sum superannuation funds was 33 cents in the dollar. However, the use of any rate between the top and bottom marginal tax rates creates an avoidance opportunity for those on higher marginal rates and disadvantages those on lower marginal rates. Clearly, no single rate can avoid both of these problems as long as scheme members are subject to a range of personal marginal tax rates.

6.7 Superannuation Schemes and the Company Imputation System

As outlined in Chapter 5, the tax exemption for superannuation schemes creates a disincentive for schemes to invest in equity and significant economic costs are incurred as a result. By bringing superannuation funds into the tax net, this problem will be avoided.

For the purposes of imputation, superannuation funds will be treated along the same lines as individual shareholders. They will be subject to tax on dividends received. Where those dividends carry with them imputation credits, those credits will be able to be used to partially or fully offset any tax liability on the dividends. Where imputation credits exceed the dividend tax liability, the excess credits will be able to be utilised to offset other tax liabilites, such as tax payable on interest income.

Example: Assume the superannuation fund is on a 25 per cent tax rate and receives a cash dividend from a company of $720. Assume the company is on a 28 per cent tax rate and is in a position to provide full imputation credits on all its distributed income.

	$
Cash dividend	720
Imputation credit	280

Taxable income	1000
Tax at 25%	250
LESS Credit	280
Net tax liability	-30
Effective post-tax dividend	750

The superannuation fund will itself pay no net tax on its dividend income but will instead be able to use the $30 credit to pay the tax liability on other income derived in the same year. For instance, the $30 excess credit will be able to be used to meet a tax liability on $120 of interest income. The effective post-tax dividend income is $750 (the $720 cash dividend plus the $30 excess credit)

If the superannuation fund had remained tax-exempt, it would have recieved the $720 dividend tax-free. This is less than the $750 effective post-tax dividend received as a result of being a taxpayer under a tax regime in which full imputation operates. Thus, in this example, by being made a taxpayer the superannuation fund is in a better tax position with respect to its dividend income than if it had remained tax-exempt.
If the superannuation scheme's tax rate remained higher than the company rate, there would be no excess imputation credit to offset other income. Imputation credits would reduce, but not entirely offset the tax liability on the dividend.

Example: Using the same assumptions as in the previous example, but with the superannuation scheme tax rate set at 33 per cent.

	$
Cash dividend	720
Imputation credit	280

Taxable income	1000
Tax at 33%	330
LESS Credit	280
Net tax liability	50
Effective post-tax dividend	670

6.8 Treatment of Superannuation Scheme Benefits

Since superannuation scheme savings will be made out of after-tax income and the income earned on those savings will be taxed as they are derived, benefits paid from a registered superannuation scheme will be tax-free. This will apply equally to pension as well as to lump sum benefits. A pension benefit is equivalent to a lump sum benefit paid out over a period of time together with the additional income derived by the fund from investing the remaining capital sum from which the pension is paid. That additional income derived by the fund will be taxable in the hands of the fund. There is therefore no justification for imposing an additional tax on that income.

The 17 December Economic Statement stated that National Superannuitant Surcharge would continue to be levied on pension benefits. The rationale is that the pension beneficiary continues, indirectly, to be the recipient of income derived on his/her behalf by the superannuation fund. This is the income earned on the capital sum invested by the fund (or a life office) in order to provide for the pension payments. However, since the fund is taxed at a flat rate, it is not possible to levy National

Superannuitant Surcharge on the fund itself. Instead the pension will be subject to the surcharge as a proxy for the surcharge which should in theory be payable on the investment earnings of the fund.

A pension will be defined as any benefit from a registered superannuation scheme which is paid out in more than one installment after the date on which the beneficiary becomes entitled to National Superannuation. Anti-avoidance rules will be necessary to prevent different installments from being paid out of different superannuation schemes.

Levying the surcharge on the full pension benefit would penalise pension benefits. Only that amount of the benefit which represents earnings derived by the fund after the beneficiary becomes entitled to National Superannuation should be surchargeable. To approximate this, one half of the pension will be deemed to be capital return and one half subject to the surcharge.

6.9 Non-registered Superannuation Funds

Member contributions to a non-registered fund will be treated in the same manner as member contributions to a registered fund - they will be made out of after-tax income. Employer contributions will be non-deductible as well as subject to fringe benefit tax. Investment earnings of such a fund will be taxed in accordance with the normal rules applying to an entity of its type, whether that be a trust, company, or deemed company. Benefits of the fund will be taxable if paid out in income form.

6.10 Non-resident Superannuation Funds

Where the income of a non-resident superannuation fund is fully liable for New Zealand tax, the fund will be deemed to be resident.

Other non-resident superannuation funds will not be entitled to register and will therefore be subject to the tax rules outlined in 6.9 above. Moreover, such a fund will be subject to the rules applying to non-resident entities outlined in the Consultative Document on International Tax Reform. Residency of a superannuation fund will be determined in accordance with normal laws on residency, including the revised residency rules for trusts set out in the Consultative Document on International Tax Reform.

6.11 Taxation of Annuities

Annuities will be taxed on the same basis as superannation pension funds. This issue is considered further in Volume 2 of this Document.

6.12 Life Insurance Premiums

Life insurance premiums other than those paid by employers are to be non-deductible, including premiums on policies of pension insurance.

The position with respect to premium payments by an employer for the benefit of an employee will be standardised. All such payments will become subject to fringe benefit tax and excluded from monetary remuneration.

All premiums paid by an employer for the benefit of the employer will be made non-deductible. This will include premiums on temporary or term policies which have previously been regarded as deductible.

6.13 Taxation of Life Office Net Investment Income

The future taxation of life offices will be the subject of a comprehensive review. This is covered in Volume 2 of this

Document. Until that review is concluded, life offices will continue to be taxed on the present basis. However, some changes will be necessary as a result of the taxation of the income of superannuation funds. This section reviews those issues requiring early resolution.

Life Office Income

An adjustment is presently made to life office investment income to reduce it by the proportion which is attributable to:

a specified mortgage repayment insurance policies;

b superannuation policies; and

c annuities granted.

A specified mortgage repayment insurance policy is defined to mean a single premium non-profit policy of life insurance issued on or before 31 March 1983, under which the sum assured is related to the amount outstanding on a mortgage of land. To avoid creating a need for such policies to be renegotiated, that adjustment will remain.

The basis of the adjustment for income attributable to superannuation policies and annuities will be changed to reflect the assessability of this income. First, an adjustment will need to be made in so far as the rate of tax on such policies differs from the life office rate of tax. A further adjustment will be required to exclude gains/losses on the sale of investments to the extent that these are attributable to superannuation policies and annuities and accrued prior to the imposition of tax on such income. The income attributable to a superannuation policy or annuity will be taxed at the appropriate rate.

Life Office Expenditure

Subject to the comprehensive review of the taxation of life offices covered in Volume 2 of this Document, existing rules on the deductibility of life office income will be retained.

Tax Rate

Since both superannuation schemes and life offices are taxed as proxies for individual investors, they should, apart from transitional measures, be taxed at the same rate.

6.14 Life Offices and the Company Imputation System

The Consultative Document on Full Imputation (at paragraph 4.8) stated that the tax payable by a life office will be excluded from the ICA and thus will not be available as an imputation credit to shareholders. Life offices will be treated under the imputation system in the same way as superannuation schemes and individual share investors. They will be taxable on dividends received but will be able to use imputation credits to offset this tax liability. Any excess credits will be able to be used to offset tax on other income. Life offices will not, however, be able to allocate imputation credits to policyholders or their own shareholders. As noted above, the tax treatment of life office income, which includes the treatment under imputation, will be considered further in Volume 2 of this Document.

As proposed in the Consultative Document on Full Imputation, imputation credits will not be able to utilised by non-residents, including non-resident life offices. Consideration will be given to deeming a life office to be a resident to the extent that its income is fully taxable in New Zealand.

6.15 Treatment of Life Office Benefits

All benefits under a life insurance policy will be tax-free irrespective of whether benefits are in the form of a lump sum or a pension. Pension benefits and annuities provided by a life office will be treated in the same manner as superannuation pension benefits. That is they will be tax-free but the (approximate) proportion which constitutes income, as opposed to a return of capital, will be subject to the surcharge. Benefits received by an employer under a "key" employee life policy will also become tax-free.

6.16 Non-resident Life Offices

The position of non-resident life offices is being considered together with the general reforms of New Zealand's international tax rules. However, in line with the tax treatment of non-resident superannuation, life benefits received in income form from a non-resident life office will remain fully taxable. This would include pension benefits, annuities and the benefits under a "key" employee life policy.

Consideration will be given to deeming certain non-resident life offices to be New Zealand residents.

6.17 Regulation of Superannuation Funds

As previously mentioned, the current regulations governing superannuation schemes provide for:

- membership of a scheme;

- when benefits may/must be paid;

- who may/must receive benefits;

- what type of benefit may/must be paid;

- where and in what a scheme may invest; and

- what information a scheme is required to provide its members and public authorities.

With the removal of taxation concessions, most of these regulations no longer become necessary. Superannuation schemes should be free to pay the type of benefit members require and should be free to vary the type of benefit over time. Nor need benefits be 'locked-in' to any particular point in time. In other words, the scheme should, if it so choses, be allowed to permit members to access benefits at any time. Of course, a scheme may wish to restrict benefit withdrawal rights, just as some bank accounts have restricted withdrawal rights. This should also be permitted.

Aside from transitional considerations, the only area where regulatory control is desirable is where it is necessary to protect the interests of consumers - i.e contributors and beneficiaries. For this purpose a minimum degree of information may be required to be given to members, the public and/or a supervisory authority.

There appears to be no justification for investment restrictions to be maintained. Trustees and managers will be responsible for their actions under general legal provisions such as trustee law.

The proposal is to remove all regulatory controls not required for transitional reasons. However, if submissions establish that particular regulations are required and justified in order to protect members and the general public, those regulations will be retained.

6.18 <u>Regulation of Life Offices</u>

Life Offices are subject to two main forms of regulatory control:

a a requirement to provide financial and investment information to the Department of Justice; and

b a requirement to deposit $500,000 with the Public Trustee.

Consideration will be given to whether the present information requirements are necessary and justified. The deposit requirement is designed to ensure that life offices operating in New Zealand have substantial financial backing. On the other hand, such a requirement probably restricts the level of competition in the industry. Continuation of the requirement therefore needs to be justified.

CHAPTER 7 - TRANSITIONAL ISSUES

7.1 Introduction

Changes to the the taxation regime always impose a degree of disruption to past decisions on investments, savings, career choice and so on. The mere fact that someone incurs a short-term cost as a result of a tax change does not, of itself, justify transitional measures. It should be remembered that costs can be incurred not only when the tax system changes but also when other policy changes are made. A recent example is the costs incurred by investors in the rural sector when necessary policy changes were made in that area.

Nevertheless transitional measures can often be desirable. In considering any appropriate measures, the objectives of the measures should be clearly defined, and their ability to meet those objectives judged.

This chapter identifies transitional objectives and sets out measures which aim to achieve those objectives for superannuation and life insurance.

7.2 Transitional Objectives

An approach of exempting existing superannuation and life insurance investors from the effects of any tax change has been rejected. Such an approach is unjustified.

Any unanticipated change in the tax system - even the most minor change in the income tax scale - alters the basis on which past investments have been made. An approach to policy formulation which does not allow for any such tax changes is clearly impractical. It would effectively cement in place for all time the existing tax system and tax rates. Moreover, policy changes in almost any area can have a similar effect as a tax change (e.g. the removal of a subsidy or a regulation can impact to the disadvantage of an

investor, and changes to the social security system can affect commitments which individuals have made).

Superannuation is not special simply because it involves long-term promises with respect to the provision of retirement income. Superannuation is clearly not the only long-term decision or commitment which can be affected by tax or other policy changes. Nor is superannuation the only means by which people make provision for their retirement. One has only to consider the position of a farmer who intends to retire on the proceeds of the sale of his farm. Past policy changes with respect to the rural sector have contributed to the decline in some rural land prices and could therefore have led to a reduction in the expected future income of retiring farmers. However, compensation has not been provided on those grounds.

Instead of exempting past investors, the objectives of transitional measures for superannuation and life insurance are:

a bringing in a non-concessionary tax regime for superannuation and life insurance at the earliest possible time so as to advance the equity and efficiency gains from such measures. In particular it is only early implementation which enables the reforms to help finance significant reductions in marginal income tax rates;

b minimising administration and compliance costs of any transitional measures;

c protecting, as far as possible, those in or near retirement who have limited opportunity to adjust to the change in tax regime;

d providing a time frame in which employers can adjust remuneration packages and schemes can be renegotiated

to reflect the change in tax regime; and

e limiting the extent to which there are short-term and abrupt withdrawals of superannuation and life office funds which could needlessly disrupt the financial markets and the real economy.

7.3 Member Contributions to Superannuation Schemes

The exemption previously applying to member superannuation contributions will be removed with effect to payments made on or after 17 December 1987. Continuing this concession would not meet any of the objectives outlined above.

In general, measures which become effective from date of announcement should be avoided. However, in this case it was felt that delaying the effective date of the measures would have enabled taxpayers to claim deductions for superannuation payments in anticipation of accessing funds within a short time. Moreover, it was desirable to remove concessions for employer and employee concessions at the same time. Continuation of the employer concession would have created even more significant opportunities for abuse.

In general, the exemption for member contributions to superannuation schemes is incorporated into PAYE deductions. Even if it had been possible to pass legislation removing the incorporation of the exemption in PAYE deductions, that would not have been administratively feasible. Employers need a lead time in order to alter their payroll systems. For this reason, the PAYE adjustment will not take effect until 1 April 1988. The removal of the exemption for the remainder of 1988/89 will be taken into account by way of reduced end of year tax refunds or increased terminal tax.

It should be noted that pay period taxpayers do not have to file an

income tax return. If they have received the superannuation deduction on a PAYE basis after 17 December 1987, that deduction will not be recovered should such taxpayers choose not to file a return. For the 1987/88 year a pay-period taxpayer is defined, broadly, to be an employee deriving less than $20,000 of salaries or wages over the year.

Although payments made after 17 December will not be deductible, deductions can still be made for payments before that date up to the full applicable maximum of $1,200 or $1,400. Thus, a person who made nine monthly payments of $133.33 to an employee superannuation scheme will be entitled to the full $1,200 deduction.

Under the present personal exemption, the maximum exemption for taxpayers joining or leaving a subsidised superanuation scheme during the income tax year is calculated as $1,200 plus $17 for each month that the taxpayer did not belong to a subsidised scheme. In recognition of the fact that the deduction is being removed from 17 December 1987, this formula will be altered for 1987/88. Taxpayers is this position will add $23 (instead of $17) for each whole month between 1 April 1987 and 17 December 1987 that they did not belong to a subsidised scheme.

7.4 Employer Contributions to Superannuation Schemes

Employer superannuation contributions made on or after 17 December 1987 will be subject to fringe benefit tax.

It was important to make this change effective from the date of announcement otherwise employers could be in a position to take advantage of any interim period by over-funding schemes.

To provide a period in which employers could re-assess remuneration packages, to allow for the necessary time for establishing administrative systems, and to reduce any incentive for employers to defer the timing of contributions, the 17 December Statement said

that the first payment would not be due until the due date for fringe benefit tax payments for the March quarter (20 April 1988), and that the rate of tax on this form of fringe benefit would be set at the outset at the rate which reflects the lower income tax rates to come into effect on 1 October 1988.

The date for first payment has now been deferred until the due date for fringe benefit tax payments for the June quarter (20 July 1988).

In light of the decision to retain a variable income tax scale, the appropriate rate of fringe benefit tax for employer superannuation contributions has been reviewed. Tax rates are considered in paragraph 7.8 below.

7.5 Superannuation Fund Net Investment Income

Transitional measures for presently exempt superannuation schemes (Class A lump sum and pension schemes) are designed to provide a period in which funds can have an opportunity to adjust to the new tax regime as well as providing a transitional period of continued favourable tax treatment to reduce the probability of abrupt scheme closures and withdrawals.

Measures announced in the Government's Economic Statement of 17 December to achieve those objectives were:

a deferring the loss of tax-exempt status to 1 April 1988. For most superannuation funds this will be the beginning of the 1988/89 income year. However, some superannuation funds, principally those within the life fund of a life insurance company, have approved balance dates other than 31 March. To avoid arbitrary penalties being imposed on those who belong to a scheme which has a balance date other than 31 March, the 1 April 1988 date will apply irrespective of the income year used by the fund. Income for an income year including 1

April 1988 will be pro-rated according to the proportion of the income year that falls after 1 April and only this portion will be subject to tax under the new rules for the income year incorporating 1 April 1988. Thus, a scheme balancing on 31 December 1988 will be subject to tax on 9/12 of the income for the scheme's 1988/89 income year. A scheme balancing on 31 September 1988 will be subject to tax on 6/12 of the income for the scheme's 1987/88 income year;

b applying the new lower rate of tax to come into effect on 1 October 1988 to previously exempt superannuation funds. In light of the changes to the proposed general tax rate scale, the appropriate rate of tax has been reviewed. Tax rates are considered in paragraph 7.8 below;

c waiving the requirement to pay provisional tax for the 1988/89 income year, with 50 per cent of terminal tax for that year being payable on the normal date for terminal tax for that year, and 50 percent of the terminal tax being payable at the date for payment of 1989/90 terminal tax. For any fund with an April to September balance date, which will have an income tax liability for the 1987/88 income year, the above rules will also apply except that no provisional tax payment will be required for 1987/88 and terminal tax for that year will be payable 50 percent at the time of normal 1987/88 terminal tax and 50 percent at normal 1988/89 terminal tax date.

These measures were aimed specifically at assisting superannuation schemes which are now exempt. Thus it was stated that the measures would be limited to existing tax-exempt superanuation funds (ie Class A lump sum funds and pension funds).

Since a Class A superannuation fund is, by definition, a pre-1982 fund, there should be no problem in identifying an existing fund.

An existing pension superannuation scheme was defined as the Government Superannuation Fund and any pension scheme which has received or receives approval or classification by the Government Actuary as a pension superannuation scheme with effect on or before 17 December 1987. The Government Actuary's approval process is still continuing under current legislation and approval is being granted to schemes whether they were lodged before or after 17 December 1987. When approval is granted, it is made effective from a specified day. Where complete documents were lodged on or prior to 17 December 1987, and the scheme had members before that day, the approval will be effective from no later than 17 December 1987. Such a scheme will therefore qualify as an "existing scheme" for the purpose of these transitional arrangements.

The approval status of an employee scheme will not be affected by the entry of a new employer. Accordingly, the addition of a new associated employer will not affect a scheme's status as an "existing pension superannuation scheme".

To reduce the possibility that these transitional measures could be abused, the 17 December Statement said that a personal (but not an employee) pension scheme will lose its status as an existing pension superannuation scheme if it accepts new members after 17 December 1987. Similarly, a lump sum scheme which changes to a pension scheme after 17 December will fall outside the definition of an existing pension scheme. For the purpose of these rules any person who had made an application in writing to join a personal pension scheme on or before 17 December will be deemed to have been accepted as a member of the scheme on or before 17 December 1987.

Following regulatory changes, if the trust deed of a superannuation scheme allows, an existing pension scheme will be able to pay out lump sum benefits without losing its "existing pension superannuation scheme" status.

New superannuation schemes will be subject to tax as from 17 December 1987 in accordance with the rules which presently hold for Class B lump sum schemes. Any changes to those rules will be made effective from the beginning of the 1988/89 income year.

7.6 Asset Valuation Questions

For those schemes which are to lose their tax-exempt status, it will be necessary for some of their assets to be valued in order to apply the income tax rules.

The general rule will be that assets will be valued (and deemed to be sold and repurchased) at market value as at 1 April 1988. This will apply for depreciation purposes and for the purpose of calculating any realised gain or loss on the sale or disposal of an investment. As a result, any unrealised gain on an investment accrued prior to that date will not be taxable. On the other hand, any loss on an investment accrued prior to that date will not be deductible.

This should ensure that superannuation funds are not taxed on gains made prior to the date at which they become taxpayers. Not allowing a deduction for previous falls in the value of investments recognises that a deduction should not be provided where a gain would not be taxable. In addition, allowing a deduction for unrealised losses on investments accrued prior to the fund becoming a taxpayer would disadvantage funds that had realised losses over that period.

Financial arrangements, as defined in section 64B(1) of the Act held by a tax-exempt superann uation fund will be subject to the same rules. Any financial arrangement held by the fund will be deemed to be acquired for market value on 1 April 1988 and income or expenditure calculated thereafter in accordance with the rules set out in sections 64B to 64M of the Act. Any financial arrangement issued by the fund will be deemed to be issued at its

base price on 1 April 1988. Base price will be the initial acquisition price (as defined in section 64B(1)) of the arrangement, less expenditure previously incurred under the financial arrangement according to the accrual rules set out in sections 64B to 64M of the Act, plus any amount payable to the fund under the financial arrangement.

Departures from these rules will be needed to meet specific cases.

First, where a fund balances on a date other than 31 March, the 1 April date will be replaced by the first day of the income year in which 1 April 1988 falls. The reason for this is that such funds will be taxed on an income year basis with an adjustment to pro-rate income between the period before and the period after 1 April 1988.

Secondly, life offices create particular problems because their superannuation funds are held in an undifferentiated life fund. Investment gains are presently fully brought into income with an adjustment to reflect the proportion of liabilities represented by tax-exempt superannuation policies. To remove the adjustment as from the first day of the income year in which they become taxpayers would result in tax being levied on investment gains accruing since date of purchase. That is clearly unacceptable. Instead, when an investment gain or loss is realised, the life office will be required to value investments as at the first day of the income year in which 1 April 1988 falls. Any gain or loss will be attributed to the tax-exempt superannuation fund on the basis of the proportion of liabilities relating to exempt superannuation policies as at that date. Any gain or loss so attributable will be non-assessable/non-deductible as the case may be. Any gain or loss after that date will be fully assessable or fully deductible as the case may be. Financial arrangements held or issued by a life office will be taxed on a similar basis.

Example: A life office balancing on 31 December acquires a property

investment in 1984 at a cost of $100,000. On 1 January 1988 it is valued at $500,000. On that date 50 per cent of office liabilities relate to exempt superannuation policies. In 1989 the property is sold for $450,000. Total realised gain is $350,000. However, there was a $400,000 unrealised gain on 1 January 1988. Of this 50 per cent or $200,000 is apportioned to superannuation and is tax-free. The remaining $200,000 is taxable. The $50,000 loss since 1 January 1988 is fully deductible. The life office's total assessable income from the investment in the 1989/90 income year is $150,000.

7.7 Superannuation Scheme Benefits

As announced in the Economic Statement of 17 December, pension superannuation scheme benefits will become tax-free (except for the National Superannuitant Surcharge) as from 1 April 1989. This exemption should, in most cases, protect the position of existing superannuation scheme pension beneficiaries and those members of a pension scheme who are near retirement.

The exemption will apply only to benefits from a registered superannuation scheme. As previously noted, a registered superannuation scheme will exclude non-resident schemes (although non-resident schemes subject to New Zealand tax will be deemed to be New Zealand resident) and will exclude schemes which do not meet regulatory requirements outlined in Chapter 6. All superannuation schemes which have or do receive Government Actuary approval under existing legislation (and which are New Zealand resident or which are deemed to be New Zealand resident) will become registered schemes provided that they complete any necessary renegotiation of the scheme prior to 1 July 1989.

7.8 Superannuation Tax Rates

The 10 February statement by the Minister of Finance, announced tax rates for superannuation schemes of 25 per cent, and a fringe benefit tax rate of 24 per cent. The fringe benefit tax rate was

set using the scheme rate for the personal tax rate and a company tax rate of 28 per cent. These rates are concessionary given that most taxpayers will be on rates of 28 per cent or higher, and most superannuation scheme income is probably attributable to taxpayers on the top 33 per cent rate.

The 17 December Statement made it clear that concessionary tax rates were to be restricted to "existing" tax-exempt superannuation funds (Class A and pension). The concessionary rates are a transitional measure to assist funds and employers adjust to the new regime. Those concessional rates will not apply to either new pension schemes or Class B lump sum funds.

Class B funds will continue to be taxed at their existing 33 per cent rate. New pension schemes will also be taxed at this rate. It is to be noted that the 33 per cent rate is still concessionary in 1988/89 when the top personal marginal rate will be 40.5 per cent. For years after 1988/89, consideration will be given to reducing this effective rate of tax. To achieve that the Committee will be asked to consider the possibility of an imputation regime for superannuation schemes.

The fringe benefit tax rate for employer contributions to new pension schemes and Class B schemes is to be set at 35 per cent. This rate corresponds to the top personal rate of 33 per cent (the top personal rate to be effective from 1 October 1988) and the company rate of 28 per cent.

Category 3 (non-approved) superannuation schemes will continue to be taxed at the top personal marginal rate (40.5 per cent in 1988/89) and contributions to such schemes will be taxed at the standard fringe benefit tax rate.

7.9 Changes to the Regulatory Regime

The current regulations governing superannuation schemes are being reviewed with the aim of removing most of the regulatory restrictions. It is intended that changes stemming from this review will be effective from 1 April 1989 when the new taxation regime comes fully into effect. Similarly, it is intended to remove restrictions on employer superannuation contributions with effect from the beginning of the 1989/90 income year.

However, regulatory restrictions on withdrawals, investments and the ability of members to access funds prior to retirement will need to be retained for those funds which continue to receive concessionary tax treatment (i.e. existing pension superannuation schemes and Class A lump sum schemes). Similarly, legislative restrictions on the deductibility of employer contributions to such schemes will need to be retained. Nevertheless, as noted above, this will not prevent an existing pension fund from altering its trust deed so as to allow lump sum retirement benefits.

7.10 Renegotiation of Superannuation Schemes

The changes to the taxation of superannuation will require schemes to consider renegotiating their terms. This is because benefits may have been promised, or may be being provided, on the basis that the superannuation scheme is tax-exempt. The taxation of scheme net investment earnings will reduce the ability of a fund to provide the benefits which have been promised. In such cases it will be necessary to reduce the level of benefits. Existing beneficiaries, and those nearing retirement, should be compensated for the reduced benefits by the removal of taxation on those benefits. However, this will not occur automatically. It will require the scheme's terms to be renegotiated.

To allow this to occur in a smooth manner which is fair to all concerned, where the change in tax regime makes changes to the terms

of a scheme's trust deed necessary, approved superannuation schemes will be required to secure the agreement of a majority of scheme participants to new terms. That agreement will need to be lodged with the Government Actuary by 1 July 1989. The Government Actuary will be empowered to decline to approve the new terms if the amendments are not equitable. There will be a presumption that an equitable basis will be one in which, calculated using any reasonable actuarial basis, the increased tax burden resulting from the removal of tax privileges falls on all members and beneficiaries as if their current proportion of the fund were distributed tax-free and then re-invested in the scheme under the new rules. If all informed parties agree to a different outcome, the approval of the Government Actuary to the amendments will be forthcoming.

The aim here is to prevent abuses. For example, to prevent scheme members from loading an undue proportion of the incidence of the tax onto scheme beneficiaries by disproportionate reductions in pension levels. It is emphasised that the discretion to withhold approval would not be expected to be exercised except in cases of abuse.

Where the Government Actuary is of the view that it is impractical or unreasonable for a scheme to secure the agreement of a majority of participants to a change to a scheme, he will be empowered to approve changes which are, in his view, equitable.

Where no changes to an approved superannuation scheme's terms are desired as a result of these tax changes, a superannuation scheme is to notify the Government Actuary of this by 1 July 1989.

The Government Actuary will be authorised to delegate his above approval powers to any person he considers qualified.

Any approved scheme which does not comply with the above requirements by 1 July 1989 will lose its status as a registered superannuation scheme.

In many cases a pension superannuation scheme does not itself provide pension benefits. Instead, the amount of the fund attributable to a retiring member is withdrawn and used by the superannuation trustees to purchase from a life office a life annuity for the beneficiary. Under existing law, the life office has not been taxed on the earnings of the sum of money invested to support the annuity. It will therefore have contracted to provide the annuity on the basis that it will derive tax-free income to fund it. Withdrawal of this tax exemption could make the annuity contract unprofitable from the life office's point of view. Since the life office may have contracted to provide a set annuity, it may have no means of adjusting the level of the annuity. The end result would be a loss for the life office and a windfall gain to the annuitant since the pension would now be tax-free. To produce a fairer result, legislation will be passed enabling life offices to reduce their obligations under an annuity contract. Again Government Actuary approval will be required, but the Government Actuary will be able to delegate his approval power to any person in any manner he sees fit.

For personal superannuation schemes there is an additional transition issue. Such schemes have very restrictive early withdrawal rights. This could lock a scheme member into a contract which the tax changes now make unfavourable. Consideration will therefore be given to legislation deeming such schemes to have early withdrawal rights. Such legislation would not come into affect until at least the end of 1988/89.

7.11 Life Insurance Transitional Measures

As announced in the 17 December Economic Statement, the exemption for premiums on pre-1984 life insurance policies will be withdrawn for payments made on or after 17 December 1987.

Employer-paid premiums for the benefit of employees made after 17 December 1987 which are not presently included in

monetary remuneration of the employee, and which are presently excluded from fringe benefit tax, will be subject to fringe benefit tax at the rate of 35 percent.

Such premium payments which are presently subject to fringe benefit tax will continue to be subject to that tax at normal rates.

Such premium payments which are now included in monetary remuneration will continue to be so included until the end of 1988/89. From the beginning of the 1989/90 income year, these payments will be excluded from monetary remuneration and, instead, be subject to fringe benefit tax at normal rates.

Employer-paid premiums for the benefit of the employer will all become non-deductible from the beginning of the 1988/89 income year. All benefits under such policies will become assessable from the same date.

The investment income of a life office will be subject to the same tax rates as Class B and new superannuation schemes - 33 per cent in 1988/89. This rate will be reviewed, and consideration given to an imputation regime, for future years.

Benefits under a policy of pension insurance will become non-assessable from 1 April 1989.

GLOSSARY OF TERMS

Allocated funding - in schemes operating on this basis, contributions (of both employees and employers) and investment earnings are allocated to separate accounts opened in respect of each scheme member.

Annuity - a series of periodic payments made to an individual, usually for his or her lifetime.

Capital income - income produced from financial or real assets.

Contributions - the amounts paid into a superannuation fund by individuals and their employers.

Defined contribution scheme - a scheme where contributions are defined in advance, usually as a fixed percentage of an employee's salary, and benefits are determined by the amount of accumulated contributions plus income earned on those contributions.

Defined benefit scheme - a scheme that provides benefits based on a pre-determined formula, usually relating the benefit level to the number of years of service and, in some cases, average or recent levels of pay.

Effective tax rate - in relation to an investment, this is the proportion of the pre-tax return on the investment that is taken in tax.

Emerging benefit - the pension or lump sum paid out to members of superannuation schemes or the lump sum paid out to life insurance policyholders.

Endowment insurance - a form of life insurance which provides for the payment of the sum insured at a specified date (the maturity date) or on death if that occurs earlier.

Fully funded scheme - a superannuation scheme that at any particular time has sufficient assets to provide for the payment of all pension and other benefits required to be paid to current and past members.

Fund accumulations - the amounts earned each year by investing the pool of money representing past contributions to, and past earnings of the fund.

Income tax - a system of taxation under which tax is levied on all income as it is derived.

Income year - the year ending 31 March. For example, the 1989 income year is the year from 1 April 1988 to 31 March 1989. Income year is defined in section 2 of the Income Tax Act.

Expenditure tax - a system of taxation under which tax is levied on income as it is spent on consumption (eg the Goods and Services Tax).

Lump sum scheme - a scheme which provides benefits in a single lump sum rather than as a pension or annuity.

Non-subsidised scheme - a scheme to which the employer does not contribute.

Penal tax **treatment** - a tax treatment which levies a rate of tax in excess of that which would normally apply.

Pure endowment insurance - a form of life insurance which provides a fixed sum on a specified date (the maturity date) and an amount related to premiums paid should the insured die before this date.

Subsidised scheme - a scheme to which an employer is liable to contribute.

Taxable income - assessable income less allowable deductions.

Tax concessions/preferences/privileges - features of the tax system which allow income to be taxed at lower rates than would normally apply, including complete exemption from tax.

Tax planning - the exploitation of tax preferences in order to reduce tax liabilities.

Tax revenue forgone - the additional amount of tax that would be collected in the absence of tax concessions.

Term insurance - a form of life insurance which provides a benefit on the death of the insured if this occurs within a specified period.

Trustees - employer and employee representatives appointed to supervise the operation of a superannuation fund.

Unbundled life insurance policy - a form of life insurance in which the savings component is explicitly identified and the return on savings is reported to the policyholder periodically.

Vesting - an arrangement in a scheme which entitles a fund member to part or all of the employer contributions, plus interest, should he or she leave the fund before retirement.

Whole of life insurance - a form of life insurance which provides a benefit on the death of the insured, irrespective of when this occurs. Premiums for such policies remain fixed for the duration of the policy.

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