

THE TAX CREDIT SYSTEM

**TAXING SUPERANNUATION FUND
AND LIFE OFFICE SAVINGS
THROUGH TAX CREDITS**

A Government Discussion Document

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The tax credit system; taxing superannuation fund and life office savings through tax credits. A Government discussion document

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PREFACE

On 3 July 1997 the Government released for public information a report prepared for it by the Working Party on the Taxation of Life Insurance and Superannuation Fund Savings - generally known as TOLIS. The Working Party had been set up to investigate means of taxing the income from these savings at rates appropriate to individual savers. In its report, TOLIS put forward three taxation options for further consideration by the Government.

Of the three options, the Government favours that involving a system of tax credits. The tax rate on fund earnings would remain at a flat 33%, but savers on lower tax rates could have the difference between 33% and their normal rate credited to their own fund account.

The Government wants a workable answer to the problem by the year beginning 1 April 1998 and is consulting with the public and industry on the implementation of the tax credit proposal. If it results that the tax credit system cannot be available by then, the Government will consider adopting a flat rate lower than 33% as a temporary measure until the tax credit system is available.

This discussion document is our main means of consulting with the public and the industry on the tax credit proposal. The proposal it outlines inevitably has some complexities, although it may be possible to simplify it as a result of consultation.

The discussion document also represents a key part of the Generic Tax Policy Process, by which major tax policy reforms are formally opened to public consultation at key points in their development.

The Government welcomes submissions on the changes outlined in this discussion document.

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1

INTRODUCTION

1.1 This discussion document outlines proposed changes to the taxation of income from superannuation and life office savings. Under the proposal, a system of tax credits will be introduced to allow savers in these products to have their investment earnings taxed at their personal tax rates. The discussion document seeks submissions on the design of the proposal. The key questions it poses to readers are:

- Are the tax law changes outlined in this document in the most workable form?
- Can the proposal be modified to produce a better result?

In particular, it may be possible to modify the proposal to make it simpler.

The need to tax savers at the right rate

1.2 The Government's objective is to introduce measures that, as far as practicable, will allow people who save through superannuation scheme membership or life insurance policies to pay income tax on their return from savings at the correct tax rate. This is the tax rate at which they would be taxed if they earned a return on their savings directly. Existing tax rules for superannuation and life insurance products do not always do this because they levy tax at the scheme and life office level at a flat 33% rate. This does not reflect the varying *effective marginal tax rates*¹ actually applying to individuals. For example, most lower income savers will have an effective marginal tax rate of 21% in the 1999/2000 income year as a result of the further tax cuts legislated to come into effect on 1 July 1998.

The main problem, then, is how to reduce the tax rate on savers who are not on the top tax rate of 33%.

The TOLIS options

1.3 A joint private and public sector working group chaired by the Retirement Commissioner, Mr Colin Blair, was set up in July 1996 to investigate this problem. As it was asked to do, the Working Group on the Taxation of Life Insurance and Superannuation Fund Savings (TOLIS) identified and developed various suitable policy options to deal with the problem. The Government released the report of the Working Group, generally known as the TOLIS report, on 3 July 1997.

1.4 The TOLIS report did not recommend one course of action for the Government. Instead it identified three options for the Government's consideration. This

¹ **Effective marginal tax rate** is the income tax rate payable on the last dollar of one's income. The calculation of this tax rate includes the tax-like effect of income targeting of government transfers (that is, the abatement of these transfers as income rises).

response was anticipated at the time TOLIS was established, since there is no perfect solution to the problem.

- 1.5 The three options identified by the TOLIS report for further consideration were:
 - Retention of a flat and final income tax rate levied at the scheme or life office level but at a lower rate than the existing 33% rate – referred to as the “revised-rate proxy option”.
 - The tax credit option, which would allow schemes and life offices to allocate taxable income to individual scheme members and policyholders so that excess tax could be refunded to the fund, for the benefit of savers on lower tax rates.
 - The qualifying fund option, which would allow different superannuation and life funds to operate for savers on different tax rates.
- 1.6 Of these options, the revised-rate proxy option and the tax credit option were considered the most viable. The main advantage of the former was that it was seen as relatively simple to operate, had low compliance costs, and was comprehensive in that it could be applied to most schemes and policies. However, it had the major disadvantage of taxing most savers at the wrong rate. Low and middle income savers would be over-taxed, and high income savers would be under-taxed. A system of tax credits was seen as more complex and less comprehensive but more accurate.
- 1.7 A key matter of concern to superannuation and life office managers was how quickly any proposal could be put into practice. In particular, they thought that it would take longer to make the tax credit system available.
- 1.8 After considering the TOLIS report in detail, the Government concluded that the accuracy of a system of tax credits outweighed any advantages of having a revised flat tax rate. Tax credits would allow lower tax rate savers to pay tax on their returns at this lower rate. Revising the flat tax rate could not achieve this without giving a substantial tax concession to higher tax rate savers.
- 1.9 The Government is also confident that it could make available a tax credit system for the income tax year beginning 1 April 1998. This would make it available for use when the next round of tax cuts comes into effect and by the time the Retirement Savings Scheme begins, should that be the result of the September 1997 referendum.
- 1.10 The tax credit system will apply to defined benefit schemes but only to the extent that investment income vests in members. It will not apply to term life insurance because such policies have no surrender value.
- 1.11 Implementing the proposal should not significantly increase the number of tax returns that have to be filed.

Implementing the tax credit system

- 1.12 This discussion document describes how a tax credit system might work.

Key features of proposal

The tax rate on superannuation fund and life office earnings will remain at 33%, but savers on lower tax rates can get the difference between 33% and their rates by means of a new system of tax credits. Tax credits will therefore allow savers to pay tax on this investment income at their personal tax rate.

Life offices and superannuation funds will decide whether they will offer tax credits to their savers, and savers can choose to receive them. Savers on tax rates of 21% or below are likely to choose to receive tax credits.

When a fund decides to allocate tax credits it must attribute its tax paid proportionately across all savers.

Annuity providers can also use the tax credit system. This will result in higher annuities for the same lump sum payment for savers on lower tax rates.

The tax credit system will apply to Retirement Savings Scheme funds, lowering the target savings level and making it easier to reach that target level.

- 1.13 The discussion document begins by describing how superannuation and life insurance savings are taxed under current rules, and how this creates a problem. After summarising the tax credit proposal, it outlines how the tax credit system would work from the perspective of providers, and that of savers. Finally, it considers how the tax credit system would operate under the Retirement Savings Scheme outlined in the white paper *You and your retirement savings; the proposed compulsory retirement savings scheme*.
- 1.14 Throughout the text the term *saver* is used to mean both members of superannuation funds and policyholders in life offices. Similarly, *fund* can mean both a superannuation fund and a life office, unless otherwise specified.

Timing of legislation

- 1.15 The Government will consider submissions and take them into account when drafting the relevant legislation for introduction into Parliament in early 1998. Since it is proposed that the tax credit system take effect from the beginning of the income tax year starting on 1 April 1998, it would come into effect for some funds before the legislation is enacted. Although the new tax credit system would be elective and a reform that should be favourable to taxpayers, it would be useful if submissions considered any issues that could arise from retrospective legislation of this type.

Making submissions

- 1.16 The Government seeks submissions on the design of this proposal. Submissions should be addressed to:

Taxation of Life Insurance and Superannuation Project
C/o The General Manager
Policy Advice Division
Inland Revenue Department
PO Box 2198
Wellington

Facsimile: (04) 474 7217

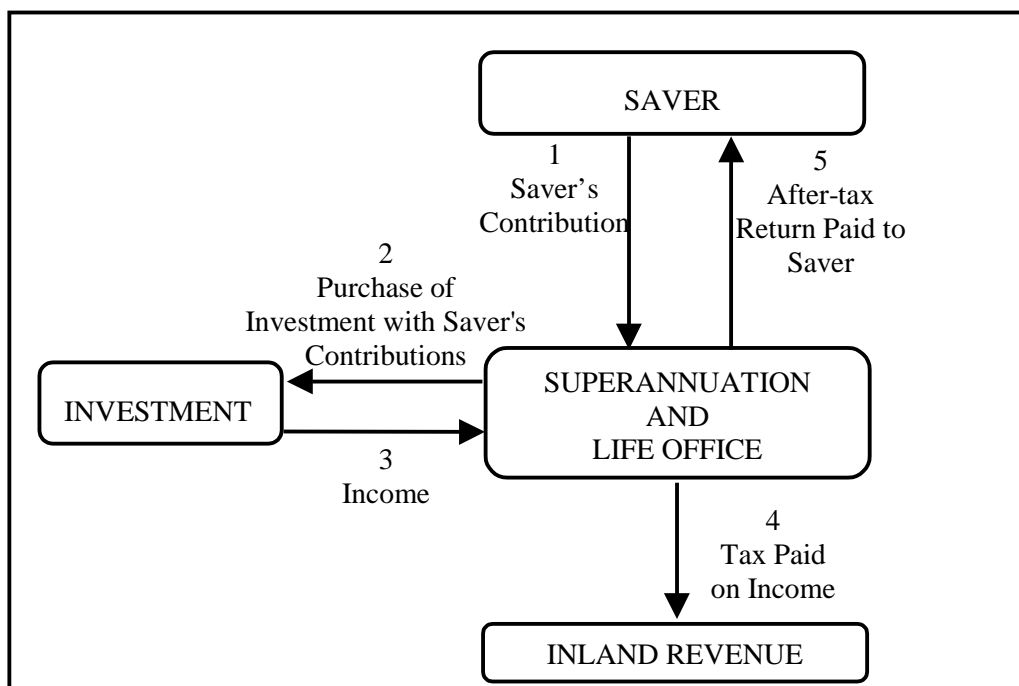
- 1.17 Submissions should be made by 12 September 1997. Submissions over one page in length should contain a brief summary of their major points and recommendations.

2

THE CURRENT TAXATION OF SAVERS

- 2.1 Under current tax rules, income from savings invested in superannuation and life insurance products is taxed at a flat and final rate of 33%. This tax is paid by superannuation funds and life offices on behalf of savers.

Figure 1. The current system

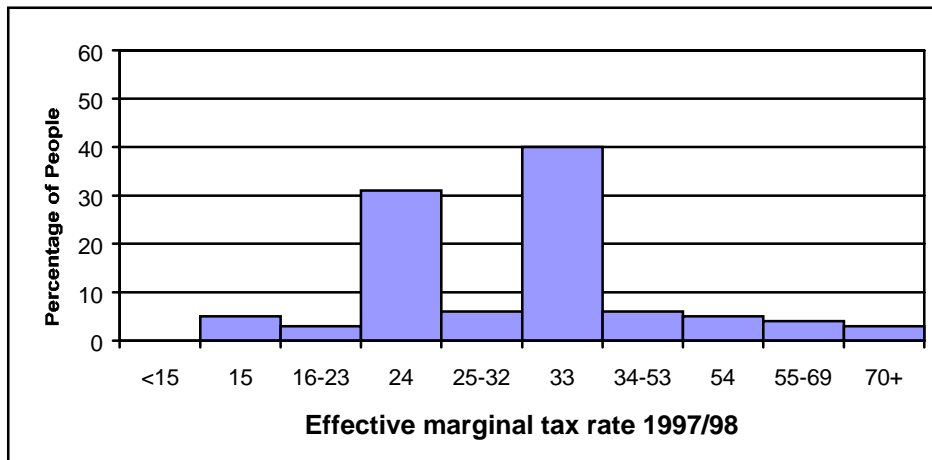


- 2.2 Superannuation funds and life offices pool savers' contributions and invest them. Likewise, they calculate the taxation on income arising from these investments on an aggregate basis. They do not attribute investment income, and the tax on that income, to individual savers. This is the main reason for taxing all funds at a flat and final rate.
- 2.3 This obviously creates a problem for savers whose personal tax rates are lower than 33%. They are over-taxed because they pay more tax on their superannuation and life office income than they do on other types of income.

Taxation of savers in superannuation funds and life offices

- 2.4 Recent research suggests that 45% of savers in superannuation funds and life offices have *effective marginal tax rates* of less than 33% in the 1997/98 income year. It also indicates two main clusters of contributors - those whose effective marginal tax rate is 24% and those whose rate is 33%. This is shown in figure 2.

Figure 2. Effective marginal tax rates faced by 25+ year-olds contributing to superannuation and/or life insurance schemes

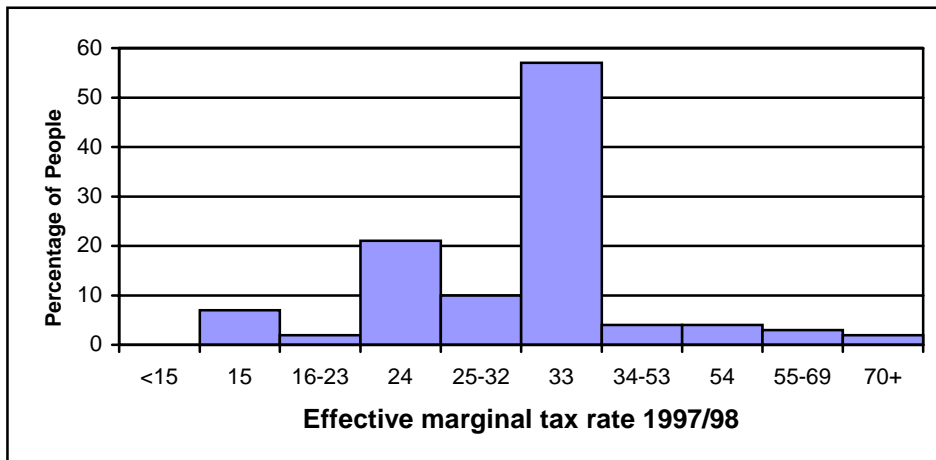


- 2.5 Superannuation and life insurance savers whose taxable income exceeds \$34,200 face the top statutory tax rate for individuals of 33%. Those with effective marginal tax rates over 33% are savers subject to social policy measures which include the New Zealand superannuitant surcharge, student loans and family support.
- 2.6 The next most common effective marginal tax rate in figure 2 is 24%. This represents savers whose taxable income is over \$9,500 but less than \$34,200. They qualify for the low income rebate on income from salary, wages or New Zealand Superannuation. The low income rebate reduces the statutory rate of 21.5% on the first \$9,500 of income to an effective rate of 15%. However, the low income rebate abates on income over \$9,500 and under \$34,200 and increases the statutory tax rate of 21.5% to an effective marginal rate of 24%. The savers with an effective marginal tax rate of 15% are those who earn under \$9,500 and qualify for the low income rebate.
- 2.7 Those who earn less than \$34,200 will not qualify for the low income rebate if they earn investment income only, unless they receive New Zealand Superannuation. They have an effective marginal tax rate of 21.5%, which is the same as the statutory tax rate.

Taxation of savers in superannuation funds only

- 2.8 Figure 3 shows that the problem of over-taxation is not quite as significant when life insurance savers are excluded from the analysis and only savers in superannuation funds are considered. Although a high proportion of superannuation savers are on an effective marginal tax rate of 33% or more, 36% are still on a tax rate of less than 33%.

Figure 3. Effective marginal tax rates faced by 25+ year-olds contributing to superannuation schemes



The Government's proposal

2.9 To resolve the problem of over-taxation of these savings, the Government favours a system that gives tax credits to savers on tax rates lower than 33%. Under this system, the tax rate on fund earnings will remain at 33%, but savers on lower tax rates can get the benefit of the difference between the 33% tax paid by the fund and their own tax rates.

Taxation of savers from 1999/2000

2.10 Tax cuts coming into effect on 1 July 1998 will reduce the lower statutory tax rate from 21.5% to 19.5%. The annual tax rates for the 1998/99 income year take into account the tax reductions and will be composite tax rates. The new tax rates become fully effective in the 1999/2000 income year. Taxpayers who do not receive social assistance such as family support will be subject to one of four effective marginal tax rates:

- The 33% rate for those whose taxable income exceeds \$38,000.
- A 21% rate for those on incomes over \$9,500 but less than \$38,000 who qualify for the low income rebate.
- A 19.5% rate for those on incomes less than \$38,000 who do not qualify for the low income rebate.
- A 15% rate for those on incomes less than \$9,500 who qualify for the low income rebate.

2.11 The largest group of superannuation and life insurance savers will remain on the 33% effective marginal tax rate. It is envisaged that these people will not choose to receive tax credits. Their superannuation and life insurance income will thus remain taxable at the correct 33% rate.

2.12 The tax credit system will provide for a refund or a reduction in the tax of the fund for the excess tax levied at the fund and life office level. This excess is the difference between the flat 33% rate and a lower rate reflecting the likely effective marginal tax rate of savers.

- 2.13 By making this lower rate as accurate as possible, the need for savers to file tax returns and pay any deficiency of tax or receive a refund for excess tax is minimised. The rate that best meets these criteria for the 1999/2000 income year is 21%. In the 1998/99 income year the corresponding rate is 21.75%.

The tax credit system and imputation

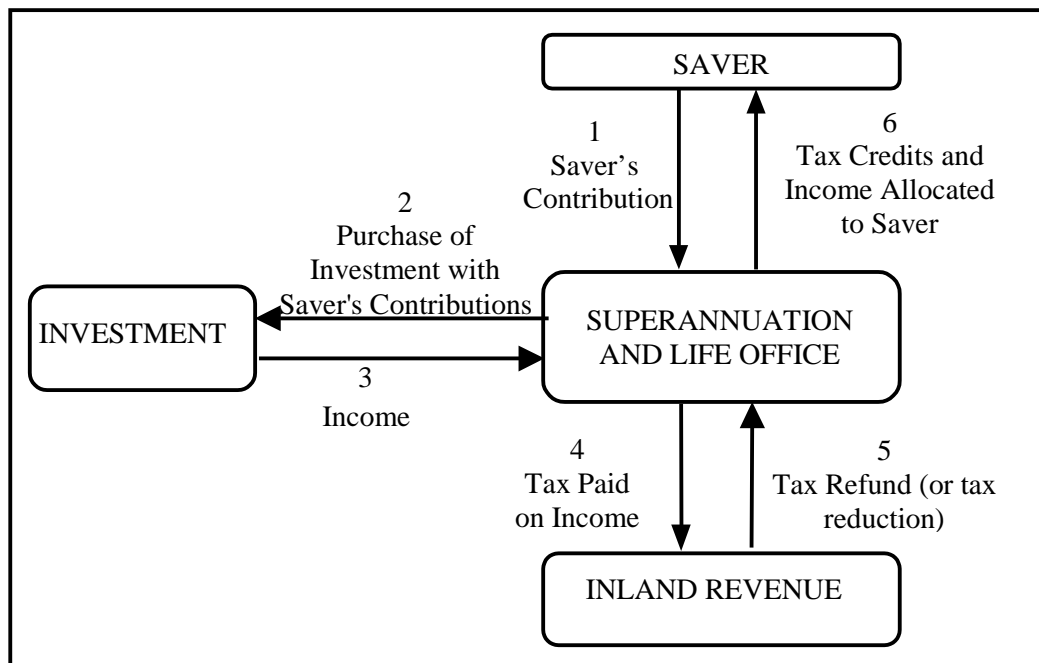
- 2.14 The proposed tax credit system is not the same as the imputation system that applies to companies and unit trusts. Under the imputation rules, all amounts received from a company or unit trust are generally taxable dividends of the shareholder or unit holder. Tax paid at the company or unit trust level is available to offset the tax liability on the dividends. However, if the dividend represents a distribution of non-taxed income, such as some foreign earnings, the shareholder or unit holder must pay the difference in tax. Since the imputation system taxes all dividends received, this amount must be measured as accurately as possible.
- 2.15 By contrast, the proposed tax credit system is optional and will apply only if the fund and the saver have chosen to adopt it. Only allocated income that is fully credited at the 21% rate will be brought into the individual saver's taxable income. Thus a superannuation fund that made a capital gain could continue to distribute that gain to savers tax-free under the tax credit system, something that would not happen under imputation.
- 2.16 The tax credit system is best viewed as a system for allocating tax credits for superannuation and life office tax payments, together with corresponding income, to individual savers. The imputation system, on the other hand, is best seen as a system of taxing all company and unit trust distributions, but with imputation credits to avoid double taxation.
- 2.17 Although there are important differences between the two systems, there are also similarities in their mechanisms. For this reason, the new tax credit rules will be based on the imputation rules when appropriate.
- 2.18 The tax credit system is discussed in detail in the following chapters.

3

HOW THE TAX CREDIT SYSTEM WILL WORK

- 3.1 Under the tax credit system, the tax rate on fund earnings will remain at a flat rate of 33%. If a fund chooses to offer the tax credit system, savers can choose to have credits, known as tax credits, allocated to them for the tax paid on their behalf by their fund. Tax credits will allow investment income to be taxed at savers' personal tax rates.
- 3.2 The tax credit system will not be available to non-residents and tax-exempt bodies.

Figure 4. The proposed tax credit system



Choosing the tax credit system

- 3.3 The tax credit system will be optional for funds and savers. If a fund offers tax credits, savers in the fund can choose to have credits allocated to them.
- 3.4 When a fund allocates tax credits to the savers who have chosen to receive them it must, at the same time, attribute tax credits proportionately across all savers, including those who have chosen not to receive tax credits. This is so the tax paid by the fund is proportionately attributed across all savers in the fund, and not just to the low income savers. (*Attribution* across savers is an anti-streaming measure and for the purposes of this proposal it is distinct from the *allocation* of tax credits to savers who choose to receive them.)

- 3.5 The fund may choose to allocate tax credits at any time during an income year. However, it is likely to allocate them at year end, given that it must attribute the tax credits proportionately across all savers.
- 3.6 For savers who have chosen to receive them, tax credits will be allocated by the fund at 21% (21.75% in 1998/99) as a credit against their personal tax liability. This reduces the need for these savers to file income tax returns.
- 3.7 It is expected that savers on a tax rate of 21% or below will choose to receive tax credits. Naturally, a saver's decision to receive tax credits will depend on his or her tax rate. In determining tax rates, social assistance based on taxable income, such as family support, needs to be considered.
- 3.8 Under the legislation, funds will be allowed refundable tax credits (as referred to in the core provisions of the Income Tax Act 1994) for that part of the full 33% tax credit that is not allocated to savers (the credit multiplied by the difference between the fund tax rate of 33% and the rate at which tax credits are allocated to savers). A fund will be able to pay less provisional tax in anticipation of a refundable tax credit, effectively gaining a refund for the difference between tax payable at the fund rate and the tax that would have been paid at the saver's personal tax rate. This refundable credit will be credited by the fund to the account of the saver who receives the tax credit.

Attribution and allocation of tax credits

- 3.9 The fund decides how many tax credits and how much income it will attribute across savers. This is similar to the decision a company makes in declaring a dividend to shareholders. However, unlike dividend income, only income with full tax credits can be attributed. Funds that choose to operate under the tax credit system will be legally required to attribute the tax they pay across all savers in the fund, in proportion to each saver's share of fund income.
- 3.10 Funds will allocate 21% tax credits, with corresponding income, to savers who choose to receive them.

Implications for savers

- 3.11 Savers who choose to receive tax credits will be notified by their fund of any allocation of tax credits and income made to them. Savers will need to include these amounts in their tax returns if they are required to file returns.

4

ATTRIBUTING AND ALLOCATING TAX CREDITS

- 4.1 Funds that choose to allocate tax credits will be legally required to attribute the tax they pay across all savers in the fund, in proportion to each saver's share of fund income, at a rate appropriate to each class of saver. The details of these rules will be determined after consultation. Consideration will also need to be given to whether it is necessary to limit the allocation of tax credits on the basis of change in surrender value.²
- 4.2 The simplest scenario is one in which a fund attributes tax across savers on the basis of a 33% tax rate, and then seeks a refund for its 21% savers who choose to receive tax credits. In practice, however, the operation is likely to be more complex. A fund will doubtless want to attribute the benefit of the tax credits to savers for purposes of calculating the surrender value of their policies, since surrender values are determined by the allocation of after-tax investment income to individual savers. Moreover, when calculating its tax payments, the fund is likely to take into account the fact that it will effectively pay tax at 21% on investment earnings attributed to 21% savers, and at 33% for the others.
- 4.3 A possible process that a fund might use to attribute tax paid across savers and allocate tax credits, as in the more complex scenario described above, is set out in the appendix. This process is merely illustrative, showing how funds could achieve a proportionate attribution of tax paid.

How savers get the benefit of the tax credit

- 4.4 Only savers who choose to receive tax credits will be allocated tax credits and taxable income. Other savers in the fund will be attributed tax credits so that tax payments are proportionately spread across all savers in the fund, and not just to those who choose to receive tax credits. Savers who choose not to receive tax credits will not necessarily be notified of these amounts and cannot take them into account in their tax return. It is likely that the attribution to all 33% savers will be on a pooled basis.

The tax credit account

- 4.5 The tax credit account will record tax paid and refunds, imputation credits received, and tax credits received (as happens with wholesale superannuation funds). This account will be a memorandum account whose operation will be similar to that of an imputation credit account. The tax credit account will also record the 21% tax credits that have been allocated to savers, and the 33% tax credits attributed to savers who do not choose to receive tax credits. Funds may carry forward unused tax credits for allocation in later years.

² *Surrender value*, which is a term more often used in relation to life insurance, is the amount payable to a saver on a particular day if the policy is discontinued. Surrender value will not include amounts that have not yet vested in the saver, such as employer contributions that have not yet vested.

- 4.6 Funds will need to provide a reconciliation of their tax credit account to Inland Revenue each year. The reconciliation will be at 31 March, the same as for imputation credit accounts. Funds will also need to provide details of the income and tax credit allocations made in the year to 31 March
- 4.7 It is not proposed to include shareholding continuity requirements in the tax credit legislation. This differs from the imputation system, which has continuity requirements in its rules.

When tax credits and income can be allocated

- 4.8 The fund can choose to allocate tax credits and income at any time, as long as it holds a valid election form from the relevant saver. An election will be valid until it is revoked. The fund may choose to confirm the election annually or before making an allocation. No specific rules will be included in legislation, apart from the requirement for the fund to obtain the saver's IRD number and declaration relating to allocations. As a practical matter, funds may place limits on when savers can provide and revoke an election. An election is likely to be required by the fund, for example, when it wants to rely on the election to pay its provisional tax.
- 4.9 A fund may seek a refund or reduce its tax liability in the income year in which it allocates a tax credit. Likewise, savers who file income tax returns must include the allocations in their tax return for the year in which they receive them. This income is akin to dividend income, so is not taken into account for purposes of the low income rebate. As with imputation credits, if savers receive excess tax credits that they cannot use against any other income, they cannot have the excess tax credits refunded to them. They can carry forward the excess tax credits as a loss carry forward for offset against their future income.

5

SUPERANNUATION FUNDS AND LIFE OFFICES

- 5.1 Superannuation funds and life offices both pay tax on behalf of savers, although they operate under different tax rules.
- 5.2 The tax rules for superannuation funds are relatively straightforward, simply requiring funds to pay 33% tax on income.
- 5.3 Life offices, on the other hand, operate under a two-tier tax system. They are taxed on the business income of the life office and on the income of the policyholders, in both cases at 33%. Tax paid on the life office business income may be used as a credit to offset tax payable on behalf of policyholders to remove double taxation.
- 5.4 The suggested process outlined in the appendix could apply to both superannuation funds and life offices. Differences in their treatment under the tax credit system are covered in this chapter, together with life annuities and multiple tax credit accounts.

Life offices and policyholder credit accounts

- 5.5 Tax paid on the life office business income may be used as a credit to offset tax payable on behalf of policyholders to remove double taxation. This is done through a policyholder credit account. It records credits (referred to as policyholder credits) for tax paid at the life office level and passed to the policyholder level. For the purposes of the tax credit system, policyholder credits can be attributed and allocated like tax credits. A tax credit account will consequently record policyholder tax credits treated in this way. The details of these rules will be determined after consultation.

Imputation credits received by life offices and superannuation funds

- 5.6 Life offices and superannuation funds will include in their tax credit accounts the imputation credits they receive from their company or unit trust investments. This is analogous to making a tax payment. Under the tax credit system, this treatment may allow a refund to the fund of 12 cents of the 33 cent imputation credit received.

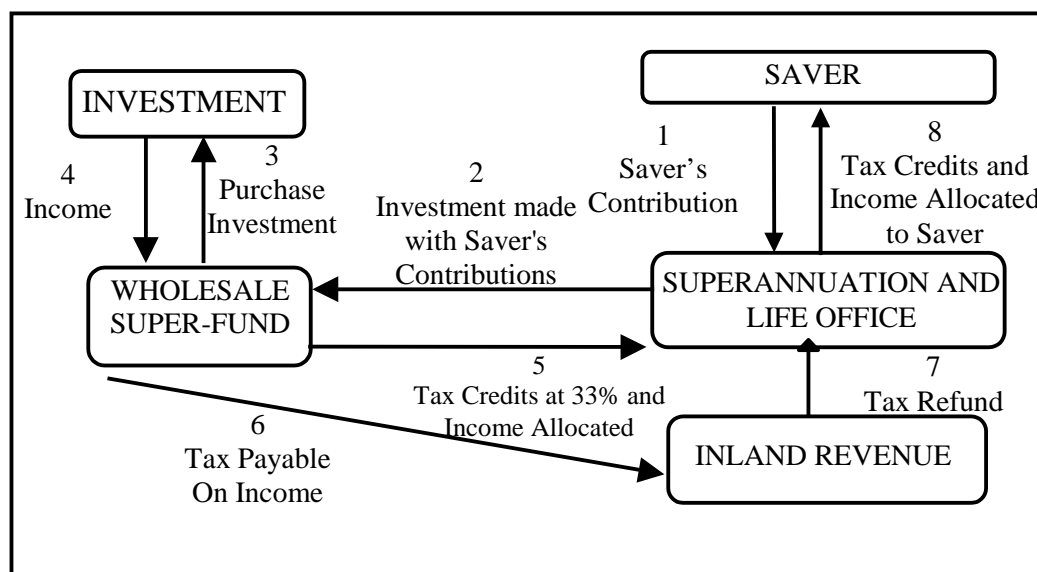
Re-investment by life offices of 12% benefit

- 5.7 An issue for life offices is the potential for double taxation when the 12% is re-invested for the saver. The Government proposes to treat the re-investment as a premium for the purposes of calculating policyholder income. This will ensure that the 12% benefit provided to the saver is not taxed again at the policyholder level.

Investment in wholesale superannuation funds

- 5.8 If a retail superannuation fund were to invest in a wholesale superannuation fund the latter could provide it with tax credits of 33% rather than 21%. The retail fund would include these tax credits in its tax credit account for attribution and allocation to savers. For allocation to 21% savers Inland Revenue would refund the balance of 12 cents to the fund, which would re-invest it for the appropriate 21% savers.

Figure 5. Investment in wholesale superannuation funds



Life annuities under the tax credit system

- 5.9 As well as benefiting those saving for retirement through superannuation and life insurance, the tax credit system will also benefit those in retirement receiving life annuities. A life annuity is a pension or regular lifetime payment made by a fund in exchange for an upfront lump sum payment. An annuity operates in a similar way to a normal home table mortgage. The fund or life office invests the lump sum payment it receives from the annuitant. It then makes regular payments to the annuitant. These payments are a mix of interest (investment earnings) and capital, as in a table mortgage. In the initial years, the payment will consist of a higher portion of investment earnings, and in the later years it will consist largely of capital.
- 5.10 Under current tax rules, the investment income derived by a fund and used to pay the annuity is taxed at a 33% rate. Normally this is under the life insurance tax rules, but employer qualifying superannuation schemes can offer annuities and be taxed under the superannuation rules.

- 5.11 It is likely that most annuitants will receive taxable income of less than \$38,000 and thus be on an effective marginal tax rate of less than 33%. Since New Zealand Superannuation qualifies for the low income rebate, and most annuitants are likely to be New Zealand superannuitants, the most common effective marginal tax rate will be 21% (using the 1999/2000 tax scale).
- 5.12 For these reasons, the tax credit system should be allowed to apply to annuities. A difficulty is that the system for applying tax credits to savers cannot apply so easily to annuitants. By definition, annuities have no surrender value.
- 5.13 It is proposed that funds and life offices offering annuities be able to use the tax credit option. The objective is that 33% taxpayers pay the appropriate rate on their share of annuity fund income, and 21% taxpayers do the same. As with the tax credit option, this generally involves a contribution of:
- Tax paid by the annuity provider at either the 21% or 33% rate.
 - Tax paid by the annuitant through individual assessment if tax paid by the annuity provider is inaccurate.
- 5.14 It is expected that annuity providers will establish a separate tax credit account for annuity business to which the tax credit system applies. Investment income will then be taxed at the 21% rate for annuitants electing into the tax credit system. Higher after-tax investment income will allow higher annuities to be paid. However, it would not be appropriate for the excess tax (the difference between tax at 33% and 21%) to be automatically re-invested in the annuity fund. That would provide a gain to the annuity provider, not the individual annuitant. Instead, this excess tax will have to be refunded to the annuitant by the annuity provider in the form of a higher annuity. The annuitant would receive a tax-free annuity (as happens now) plus a taxable amount backed by tax credits. The maximum tax credits available to each annuitant would be the tax associated with his or her proportion of investment income. This can be measured over a year as:
- The decrease in actuarial reserves associated with that annuity policy.
 - Plus annuity payments.
 - Less any premium.
- 5.15 Obviously, investment income and associated tax refunds will vary over the course of an annuity. Initially, investment income will be a large proportion of the annuity but this will fall over time. Annuity providers should be able to vary capital and income components of the annuity to maintain a constant annuity payment, as they do now. In effect, the tax credit system is merely an increase in investment income, but one that has to be passed on to annuitants.

Multiple tax credit accounts

- 5.16 To allow for different types of policies, a fund may establish separate tax credit accounts for each type of policy. These separate accounts will record the tax paid in respect of the particular policies involved. An annuity fund, as mentioned above, could be one of these separate accounts. Separate accounts may also reflect different investment and tax profiles of policies. For example, a life office may operate, within the one life fund, a set of policies limited to foreign equity investment and another set of policies limited to bonds. The tax profile of the investments backing these different policies will vary, making it desirable for different levels of tax to be associated with each product type. It will be necessary to have actuaries verify these separate accounts, just as they do under the current life insurance tax rules. It is envisaged that this will reflect the accounting policies of the fund.

6

TAX CREDITS FROM THE SAVER'S PERSPECTIVE

- 6.1 The tax credit system will allow savers to pay tax on their investment income at their personal tax rate. This means taking into account savers' other income, the low income rebate when applicable, and social assistance such as family support.
- 6.2 The following examples show the effects of tax credits on savers with different incomes. They take into account the fact that both the individual tax rate scale and the low income rebate will change from 1 July 1998. The examples cover the 1999/2000 tax year.
- 6.3 The savers in the examples have chosen to receive tax credits. They have been advised by their fund that \$1500 in income, including \$315 in tax credits, has been allocated to them for the income year ended 31 March 2000.

Saver whose income is under \$9,500

- 6.4 Saver A has employment income of \$6,000. She has attributable income from her superannuation fund of \$1,500, which includes tax credits of \$315. How the tax she has to pay is calculated and how she meets the payment - through a combination of tax credits and PAYE deductions - are shown below.

Saver A: income under \$9,500

	1999/2000
Taxable income	\$7,500.00
Calculating tax to pay:	
Tax payable on income (at applicable statutory rate, 19.5%)	\$1462.50
Less low income rebate	<u>(\$270.00)</u>
Tax payable	\$1,192.50
Payment of tax:	
Deduct tax credit	(\$315.00)
PAYE deductions	<u>(\$900.00)</u>
Tax to pay (refund)	(\$22.50)

Saver A will be entitled to a refund of \$22.50. This happens because the tax credit is 21% of \$1,500, whereas the marginal tax rate on this income is only 19.5% because it does not qualify for the low income rebate.

Saver whose income is over \$9,500 but under \$34,200

6.5 Saver B’s employment income is \$18,000. His superannuation fund attributes income of \$1500 to him, a sum that includes tax credits of \$315. How the tax he must pay is calculated and how he pays the tax – through a combination of tax credits and PAYE deductions – are shown below.

Saver B: \$9,500 - \$34,200

	1999/2000
Taxable income	\$19,500.00
Calculating tax to pay:	
Tax payable on income (at applicable statutory rate, 19.5%)	\$3,802.50
Less low income rebate	<u>(\$277.50)</u>
Tax payable	\$3,525.00
Payment of tax:	
Deduct tax credit	(\$315.00)
PAYE deductions	<u>(\$3,210.00)</u>
Tax to pay	\$0.00

He will have no extra tax to pay because his effective marginal tax rate and the tax credit rate are both 21%.

Saver whose income is over \$34,200 but under \$38,000

6.6 Saver C has employment income of \$36,000. He has attributed income of \$1,500 from his superannuation fund, which includes tax credits of \$315. How the tax he has to pay is calculated and how he meets that payment - through a combination of tax credits and PAYE deductions - are shown below.

Saver C: \$34,200 - \$38,000

	1999/2000
Taxable income	\$37,500.00
Calculating tax to pay:	
Tax payable on income (at applicable statutory rate, 19.5%)	\$7,312.50
Less low income rebate	<u>\$7.50</u>
Tax payable	\$7,305.00
Payment of tax:	
Deduct tax credit	(\$315.00)
PAYE deductions	<u>(\$6,990.00)</u>
Tax to pay	\$0.00

He will have no extra tax to pay because his effective marginal tax rate will also be 21%.

Saver whose income is over \$38,000

6.7 Saver D's employment income is \$50,000 a year. She has attributed income of \$1,500 from her superannuation fund, which includes tax credits of \$315. How the tax she has to pay is calculated and how she pays it - through a combination of tax credits and PAYE deductions - are shown below.

Saver D: income over \$38,000

	1999/2000
Taxable income	\$51,500.00
Calculating tax to pay: Tax payable on income (at applicable statutory) (rates, 19.5% and 33%)	<u>\$11,865.00</u> (33%)
Tax payable	\$11,865.00
Payment of tax: Deduct tax credit	(\$315.00)
PAYE deductions	<u>(\$11,370.00)</u>
Tax to pay	\$180.00

She will have to pay extra tax because her marginal tax rate is 33%, whereas the tax credit rate is 21%. Had she not elected to receive tax credits, her taxable income would have consisted only of employment income.

Social assistance

- 6.8 Some Government social assistance is based on the level of the recipient's taxable income. Social assistance includes family support, student loans, student allowances and child support. Savers who receive this sort of social assistance will need to be aware that if they receive tax credits they will increase their taxable income. Consequently, these savers may be advised not to choose to receive tax credits.
- 6.9 Take the example of a saver who receives family support. She has one dependent child and her income is over \$20,000 a year. Consequently, the income allocated to her so she can receive a tax credit will also reduce her family support. If she chooses not to receive tax credits, there will be no effect on her family support.
- 6.10 The reason for this is that family support is targeted to low-income earners and begins to abate when a recipient's income is over \$20,000.

THE TAX CREDIT SYSTEM AND THE RSS

- 7.1 The tax credit system described in the preceding chapters would operate in the same manner under the Retirement Savings Scheme (RSS).
- 7.2 The detailed design of the RSS proposal was announced on 7 July 1997 through the release of the white paper *You and your retirement savings; the proposed compulsory Retirement Savings Scheme*.
- 7.3 The white paper stated that RSS fund earnings would be subject to the same tax treatment as existing superannuation funds. The white paper noted that such earnings are now taxed at a flat and final rate of 33 cents in the dollar, but that future decisions by the Government on the tax treatment of superannuation and life insurance would be incorporated into the RSS regime.

How the RSS would operate

- 7.4 Under the RSS, people who earned over \$5,000 a year would pay a percentage of their earnings into a private sector retirement fund of their choice. RSS contributions would start at 3% of earnings in 1998/99. In subsequent years, contribution rates would increase, as long as it was possible to make fiscally sustainable tax cuts that broadly matched the overall increase in contributions. The intention would be to increase contributions to 8% of earnings as soon as possible, and within five years if fiscally sustainable.

How the tax credit system would operate under the RSS

- 7.5 The tax credit system described in this discussion document would not directly affect the required RSS contribution rate or the basis for determining required RSS contributions.
- 7.6 Nevertheless, it would enable savers to pay the correct level of tax on the investment earnings of an RSS fund in the same way that they could pay the correct rate of tax on any other superannuation scheme or life office earnings.

Advantages of the tax credit system under RSS

- 7.7 The main advantages of taxing superannuation and life insurance income through tax credits under the RSS are:
- Income attributed under the tax credit system by RSS funds would not be included in income subject to required RSS contributions.
 - The RSS target savings level would be lower by about \$9,000.
 - More people would reach the target savings level, and faster, because the returns on RSS savings of lower income earners would be taxed at a lower rate.

The tax credit system and RSS contributions

- 7.8 Under the tax credit system, tax refunds would be returned to the RSS fund, not the contributor, and re-invested. Just as the fund's investment earnings would not be counted as a required RSS contribution, so reduced tax on those earnings re-invested in the fund should not be counted as a required RSS contribution. The reduced tax on the fund would simply represent higher after-tax earnings of the fund. This means that a saver's attributed income from RSS savings would not be included in the income on which the RSS contribution requirement would be based. Nor would the attributed income, re-invested in the scheme, be counted as an RSS contribution.
- 7.9 On the other hand, attributed income from a non-RSS superannuation scheme or life policy would be counted as income subject to the RSS contribution requirement. The income from a non-RSS fund would be investment income similar to that from a bank account, unit trust or company under normal RSS rules. Interest and dividend income would be subject to the RSS contribution requirement from 1 April 1999. Attributed income from a non-RSS fund would be treated under the same RSS rules as normal interest or dividend income.

Reaching the target savings level faster

- 7.10 If savers who chose to receive tax credits had a tax rate lower than 33%, the excess tax would be refunded to the RSS fund and re-invested in that fund. As a result, the fund would build up to the target level, stated in the white paper to be not more than \$120,000, faster than it would otherwise.
- 7.11 Indeed, the tax credit system would work better for RSS funds than for many existing superannuation schemes and life office policies. This is because, under the RSS, 90% of fund earnings would have to be attributable to individuals within two years of being derived by the scheme. This means that most RSS income could be attributed to individual scheme members within a short period of time.

A lower savings target level

- 7.12 The RSS target level would be lower under the proposed tax credit system. The target level in the white paper was based on existing law, under which annuity providers are taxed at a flat 33% rate on their income. Under the proposed tax credit system, the tax rate on annuity providers would generally fall to 21% in 1999/2000. With a lower tax rate, a lower lump sum could provide the RSS guaranteed annuity level of 33% of the average ordinary time wage (after tax) for an individual and 66% for a married couple. It is estimated that the target savings level under RSS would reduce under the tax credit proposal by about \$9,000.

The surrender value of an RSS fund

- 7.13 Under the RSS rules, RSS savings could be withdrawn from a registered fund only in limited circumstances, to buy an annuity or to transfer to another RSS fund. For the purposes of the tax credit proposal, the surrender value of an RSS fund would be the amount that could be transferred to another RSS fund.

RSS annuities and the tax credit system

- 7.14 Under the tax credit proposal, a recipient of an RSS annuity would be treated the same way as a recipient of any other annuity. If he or she chose to receive tax credits, the annuity provider would be taxed at the 21% rate. The difference between tax at 33% and 21% would be refunded by the annuity provider directly to the annuitant. This would increase the annuity payment, thus reducing the target savings level under the RSS.
- 7.15 Annuitants on a 33% tax rate could still choose to enter the tax credit system. They would then, in effect, be treating investment income on the annuity as their first dollars of taxable income. Provided they paid tax on the remainder of their investment income up to \$38,000 at the 19.5% tax rate, with income over that being taxed at the 33% rate, they would have no further tax to pay. Of course, they might choose not to receive tax credits and therefore to pay tax at 33% on their RSS investment annuity income, with a corresponding lower tax on their other investment income.
- 7.16 In none of these cases would people be disadvantaged relative to the current New Zealand Superannuation scheme. The current scheme sets the minimum after-tax superannuation payment for a married couple at 65% of the after-tax average ordinary time wage. The 65% would, in effect, be increased to 66% under the RSS.

APPENDIX

POSSIBLE PROCESS FOR ATTRIBUTION AND ALLOCATION

The process described here should serve to confirm that tax credits have been attributed proportionately to fund income. The process has three main parts:

- Calculation of an individual saver's share of fund income (referred to as *tax credit value*).
- Attribution of tax paid (tax credits) across all savers.
- Allocation of tax credits to 21% savers.

A. Saver's share of fund income

(1) Determine tax credit value for each saver

Tax credit value approximates the after-tax income of the saver. This value needs to be calculated to determine the individual saver's share of the fund's income. This is also the maximum amount of a fund's investment income that could be attributed to each saver under this proposal. The TOLIS report suggested that what is referred to in this document as *tax credit value* was the annual change in surrender value less contributions plus claims or withdrawals for that year. This is the basic formula:

$$\begin{aligned} & \text{Closing surrender value (at time of allocation or end of year)} \\ - & \text{Opening surrender value (later of opening surrender value at the beginning} \\ & \text{of the year or closing surrender value at time of last allocation)} \\ - & \text{Contributions made in that period} \\ + & \text{Claims paid in that period} \\ = & \textit{Tax credit value} \end{aligned}$$

However, the calculation above does not take into account *tax credit values* from previous periods that have not carried tax credits. This could create technical difficulties. For example, the surrender value of a policy could increase as a result of investment earnings that do not give rise to a tax liability until a later year. In that later year there may be no rise in surrender value and thus no attributed income to match the tax payable. Similarly, losses in one year would not be able to offset gains in a subsequent year. Therefore a fund could choose to determine and record *tax credit values* that do not carry tax credits. It would then carry forward these amounts, which could be positive or negative. If it wishes to do this a fund could use a more complex formula for calculating *tax credit value*, as follows:

$$\begin{aligned} & \text{Closing surrender value (at time of allocation or end of year)} \\ - & \text{Opening surrender value (later of opening surrender value at the beginning} \\ & \text{of the year or closing surrender value at time of last allocation)} \\ - & \text{Contributions made in that period} \\ + & \text{Claims paid in that period} \\ +/- & \text{Unallocated } \textit{tax credit value} \text{ brought forward} \\ = & \textit{Tax credit value} \end{aligned}$$

If a fund is unable to calculate the carry forward amount or considers the compliance costs of determining and recording these amounts too onerous it can choose to use the basic formula. If the fund chooses to use the more complex formula it must use it consistently.

In the first year of offering the tax credit system, the opening surrender value will be as at the beginning of that income year. The tax credit system will be available for funds to offer from the income year beginning 1 April 1998. If savers choose to receive tax credits in subsequent years their opening surrender value will be as at the beginning of the income year they choose to receive tax credits. The opening surrender value will be re-set if a saver goes in and out of the system.

In practice, a fund will usually need to attribute tax credits before calculating the *tax credit value*. That is because surrender values are determined by the allocation of after-tax investment income to individual savers. The fund will need to know, therefore, what tax is to be attributed to individuals in order to calculate changes in surrender value. One way to achieve this is for the fund, when determining surrender values, to allocate pre-tax earnings to individual savers, then deduct tax at 21% for savers choosing to receive the tax credits and 33% for other savers.

A simple example of the calculation of a saver's *tax credit value* for two years follows.

An individual saver's surrender value in a life policy at 1 April 1998 is \$5,000. The saver chooses to receive tax credits. The fund decides to allocate tax credits at the end of its income year, 31 March 1999. The saver's surrender value at 31 March 1999 is \$6,500. The saver has made contributions during the year of \$500. She has made no claim under her policy in the income year.

Since this is the first year that the fund has offered the tax credit system there is no unallocated *tax credit value* to carry forward. Therefore the *tax credit value* is \$1,000, calculated as follows:

Closing surrender value at the time of allocation	\$6,500
- Opening surrender value (as at the beginning of the year when tax credit system is first offered)	\$5,000
- Contributions	\$500
= <i>Tax credit value</i>	\$1,000

Instead of attributing \$1,000 of income, the fund, in fact, decides to attribute \$800 of income plus tax credits at 31 March 1999. This will leave \$200 of unallocated *tax credit value* to carry forward.

The fund then decides to allocate further tax credits at 31 December 1999. The saver's surrender value at 31 December 1999 is \$7,300. She has made contributions of \$500 during the period. She has made no claim under her policy for that period. Therefore the *tax credit value* is \$500, calculated as follows:

Unallocated tax credit value carried forward	\$200
+Closing surrender value at the time of the allocation	\$7,300
- Opening surrender value	\$6,500
- Contributions	\$500
= <i>Tax credit value</i>	\$500

B. Attribution of tax credits across all savers

(2) Calculate total tax credit values for savers who choose to receive tax credits and those who do not

Since it is assumed that the fund will pay tax through the year on the basis that it will get a tax reduction for those electing to pay tax at 21%, the fund must calculate how much income and tax are attributable to 33% and 21% savers respectively. It does this first by calculating the post-tax income (represented by the total *tax credit values*) for savers who choose to receive tax credits. This total is referred to as the *21% savers tax credit value pool*. It also calculates total *tax credit values* for savers who choose not to receive tax credits. This total is referred to as the *33% savers tax credit value pool*.

For the purposes of our example, in the 1999/2000 income year the *21% savers tax credit value pool* is \$158,000. This would include our individual savers *tax credit value* from the example in (1) above, \$500. The *33% savers tax credit value pool* is \$134,000.

(3) Calculate pre-tax income attributable to both pools based on tax credit value

In (2), above, post-tax income attributable to the two groups of savers is calculated. In (3) these amounts are grossed up to pre-tax figures. For the sake of simplicity, this example assumes full tax has been paid on the income. Amounts not covered by tax credits should be removed from the *tax credit value* before the following formula is applied. After this calculation, amounts not covered by tax credits should be included in the remainder of the calculations in this process. For the *21% savers tax credit value pool* this pre tax amount would be calculated as follows:

$\frac{\text{21\% savers tax credit value pool}}{0.79(=1-\text{tax rate of 21\%})}$

$$\frac{\$158,000}{0.79} = \$200,000$$

This amount is referred to as the *21% savers' taxable income based on the tax credit value pool*.

For the *33% savers tax credit value pool* this would be calculated as follows:

$$\frac{\text{33\% savers tax credit value pool}}{0.67(=1-\text{tax rate of 33\%})}$$

$$\frac{\$134,000}{0.67} = \$200,000$$

This amount is referred to as the *33% savers' taxable income based on the tax credit value pool*.

(4) Calculate total taxable income for both pools based on tax credit value

This is simply the total fund pre-tax income using the previous calculations.

$$\$200,000 + \$200,000 = \$400,000$$

It is referred to as *total taxable income based on the tax credit value pools*.

(5) Calculate actual taxable income attributable to each pool

By dividing each pool's *taxable income based on the tax credit value pool* (3) by *total taxable income based on the tax credit value pools* (4) the proportion of taxable income attributed to both pools is calculated. Multiply this by the *actual taxable income* of the fund (which excludes untaxed fund income such as capital gains). This apportions *actual taxable income* fairly across both pools.

$$\frac{\text{21\% savers' taxable income based on the tax credit value pool}}{\text{Total taxable income based on the tax credit value pool income}} \times \text{actual taxable income}$$

For the purposes of this example *actual taxable income* for the 1999/2000 income year is \$400,000.

$$\frac{\$200,000}{\$400,000} \times \$400,000 = \$200,000$$

$$\frac{\text{33\% savers' taxable income based on the tax credit value pool}}{\text{Total taxable income based on the tax credit value pool income}} \times \text{actual taxable income}$$

$$\frac{\$200,000}{\$400,000} \times \$400,000 = \$200,000$$

In this case no untaxed fund income is reflected in the savers' surrender values and thus in their *tax credit values*. If there were such untaxed income but the fund wanted to ensure *tax credit values* were fully attributed, the fund could calculate the above with an increased *actual taxable income* amount.

(6) Calculate tax on each pool's taxable income

This is simply the *actual taxable income* for each pool (5) multiplied by the appropriate tax rate.

$$\$200,000 \times 0.21 = \$42,000 \text{ (for the 21\% pool)}$$

$$\$200,000 \times 0.33 = \underline{\$66,000} \text{ (for the 33\% pool)}$$

$$\text{TOTAL} \qquad \qquad \$108,000 \text{ (for both pools)}$$

These figures are referred to as the *tax liability* of each pool. The total is the amount the fund should pay in tax. This is not necessarily the *actual tax paid* by the fund.

(7) Determine tax paid by each of the pools

The next step is to reconcile *tax liabilities* (6) with *actual tax paid* by the fund since only *actual tax paid* can give rise to credits. This is done by apportioning *actual tax paid* to each pool based upon its *tax liability* (6). For the purposes of this example, the *actual tax paid* by the fund is \$108,000.

$\frac{21\% \text{ savers' tax liability} \times \text{actual tax paid}}{\text{Total savers' tax liability}}$

$$\frac{\$42,000}{\$108,000} \times \$108,000 = \$42,000$$

This amount is referred to as the *21% savers' tax paid*.

$\frac{33\% \text{ savers' tax liability} \times \text{actual tax paid}}{\text{Total savers' tax liability}}$

$$\frac{\$66,000}{\$108,000} \times \$108,000 = \$66,000$$

This amount is referred to as the *33% savers' tax paid*.

The tax credits available for attribution across all savers equal the tax payments made by the fund. Tax credits can be attributed to savers before making the tax payment. However, the fund will be required to reconcile the tax credits attributed and the tax paid annually, as for imputation credits. Tax payments will not include foreign tax credits, penalties or use of money interest. Tax payments from the beginning of the income year in which the fund offers the tax credit system can be included.

C. Allocation of tax credits to 21% savers

(8) Determine amount of tax paid at the 21% rate for each of the 21% savers

The 21% savers' tax paid must now be allocated to each 21% saver. This is done on the basis of the proportion of *tax credit value* each saver has, compared with the 21% savers tax credit value pool. The amount of tax paid at 21% by a 21% saver with a \$500 tax credit value, as in the example in (1), above, is calculated as follows:

$$\frac{\text{Individual saver's tax credit value}}{\text{21\% savers tax credit value pool}} \times \text{21\% savers' tax paid}$$

$$\frac{\$500}{\$158,000} \times \$42,000 = \$132.91$$

This is the maximum tax credit that can be allocated to the 21% saver if there is sufficient *tax credit value* with which to allocate it.

(9) Determine the maximum income that can be allocated to the 21% saver based on the maximum tax credit

All income allocated to individual savers must be credited at the maximum rate of 21%. The maximum credited amount is calculated as follows:

$$\frac{\text{Tax credit}}{0.21 \text{ (tax rate of 21\%)}} = \text{maximum allocated income}$$

This is similar to the maximum imputation credit formula of:

$$\frac{\text{Imputation credit}}{0.33} = \text{maximum imputed dividend distributed}$$

$$\frac{\$132.91}{0.21} = \$632.91$$

This is the saver's maximum tax credit income based on 21% tax credits.

(10) Compare saver's maximum tax credit income with individual savers' grossed up tax credit value

The saver's maximum tax credit income is \$632.91. His grossed up *tax credit value* is \$632.91.

Given that the saver's maximum tax credit income is not greater than his grossed up *tax credit value*, his maximum *tax credit value* can be allocated as income with tax credits. The 21% tax credit included in this amount is \$132.91.

(11) Determine the amount of tax credits to be allocated

The amount of 21% tax credits allocated with *tax credit values* must be in proportion to the tax credits attributed to the 33% savers.

(12) Determine the income and tax credits to be attributed to the 33% savers

Based on the *33% savers' tax paid* being the maximum tax credit attributable to 33% savers, the maximum income that could be attributed is calculated as follows:

$$\frac{\text{33\% saver's tax paid}}{0.33 \text{ (tax rate of 33\%)}}$$

$$\frac{\$66,000}{0.33} = \$200,000$$

Compare this amount to the 33% savers' grossed up *tax credit value* pool, which is \$200,000. Given that the maximum tax credit income is not greater than the 33% savers' grossed up *tax credit value* pool, the maximum *tax credit value* for the pool can be attributed to the 33% savers. The tax credits attributed to the 33% savers would be \$66,000. The tax credits will be attributed to the 33% savers on the same basis as the allocation in (11), above, that is, in the same proportions.

Saver's benefit

Using the example above, taxable income of \$632.91 will be allocated to the 21% saver. This amount includes \$132.91 of tax credits (9). The benefit of the tax reduction or refund to the fund, re-invested for the saver, is \$75.95 (0.12 x \$632.91). This is the difference between tax at 33% and 21%.