

Countering extreme salary sacrifice

Ensuring that employer superannuation contributions are taxed fairly

An officials' issues paper

February 2006

*Prepared by the Policy Advice Division of the Inland Revenue Department
and by the New Zealand Treasury*

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1. Improving the SSCWT rules

- 1.1 Employees can arrange their remuneration so that it is taxed at lower rates by “sacrificing salary” in return for increased employer superannuation contributions. Employer superannuation contributions are taxed through Specified Superannuation Contribution Withholding Tax (SSCWT).
- 1.2 In some circumstances, the SSCWT rules can allow the use of tax rates that are lower than the rates used in the calculation of an employee’s income tax. By arranging to receive much less remuneration as salary or wages, but much more remuneration as employer superannuation contributions, employees can gain access to these lower rates, thereby decreasing their overall tax liability. In some cases, people earning comparatively high levels of income can reduce their tax so that they are paying significantly less than other taxpayers who earn the same or less income.
- 1.3 Some degree of salary sacrifice can be part of usual employment arrangements, but sometimes it is used for the reason of reducing tax rather than for the purpose of saving. There are a number of tax schemes that use extreme salary sacrifice to minimise the amount of tax that participants pay, behaviour that can undermine the fairness of the tax system. Moreover, there are costs to the economy when taxation rules encourage people to rearrange their affairs for no benefit besides reducing tax. The rules for calculating SSCWT could be changed so that opportunities to engage in extreme salary sacrifice for no reason other than reducing tax liabilities are reduced.
- 1.4 In addition, the rules for calculating SSCWT have become more complex over time. New rules have been introduced to meet specific needs, which has resulted in four options for calculating tax on employer superannuation contributions, not all of which are being used. The SSCWT rules could be simplified by removing those unused options.
- 1.5 This issues paper, which has been prepared by officials from the Policy Advice Division of Inland Revenue and from the Treasury, describes the operation of the SSCWT rules, and suggests ways of countering extreme salary sacrifice. It also suggests reducing the complexity of the rules by reducing the number of ways that SSCWT can be calculated.
- 1.6 The paper seeks views on the suggested changes before we make recommendations to the government, which has indicated that it would like to see legislative changes included in a taxation bill to be introduced in the first half of 2006.

Summary of suggested changes

- 1.7 The changes suggested in this paper would improve fairness by reducing the opportunity to minimise tax through salary sacrifice, and make the rules simpler by reducing the number of methods for calculating tax on employer superannuation contributions.
- **Changing the progressive scale.** We suggest amending the progressive scale used for calculating SSCWT so that the applicable rate is based on the sum of salary or wages and employer superannuation contributions, and at the same time increase the thresholds for the rates by 15% (over the corresponding effective income tax thresholds), in order to improve fairness.
 - **Reducing complexity.** We suggest repealing methods of calculating SSCWT that are not being used, in order to reduce complexity.
- 1.8 The suggested changes would apply from 1 April 2007.

How to make a submission

- 1.9 We would appreciate receiving any comments on the suggested changes by 15 March 2006.
- 1.10 Submissions should be sent to:
- SSCWT and salary sacrifice project
C/- Deputy Commissioner, Policy
Policy Advice Division
Inland Revenue Department
P O Box 2198
Wellington
New Zealand
- 1.11 Alternatively, submissions can be made in electronic form, in which case “SSCWT and salary sacrifice project” should appear in the subject line. The electronic address is:
- policy.webmaster@ird.govt.nz
- 1.12 Please note that submissions may be the subject of a request under New Zealand’s Official Information Act 1982. The withholding of particular submissions on the grounds of privacy, or for any other reason, will be determined in accordance with that Act. If there is any part of your submissions that you consider could properly be withheld under that Act (for example, for reasons of privacy), please indicate this clearly in your submission.

2. Taxing employer superannuation contributions

2.1 Four methods can be used for calculating tax on employer superannuation contributions.

- **Flat 33%.** SSCWT can be calculated at a flat rate of 33%, applied to all contributions made on behalf of a particular employee.
- **Progressive scale.** SSCWT can be calculated at rates of either 15%, 21% or 33%, applied to all contributions made on behalf of a particular employee, with the applicable rate determined by that employee's salary or wages in the previous year. When the employee is new, an estimate of current year salary or wages may be used to determine the applicable SSCWT rate. (This method requires the employer to elect that to use it.)

Effective rates and thresholds

Salary or wages:	Effective income tax rate	SSCWT rate
Up to \$9,500	15%	15% on all contributions
From \$9,501 to \$38,000	15% to \$9,500, 21% thereafter (average rate = 19.5%).	21% on all contributions
From \$38,001 to \$60,000	19.5% to \$38,000, 33% thereafter	33% on all contributions
From \$60,001	19.5% to \$38,000, 33% from \$38,001 to \$60,000, 39% thereafter	33% on all contributions

- **Flat 39%.** SSCWT can be calculated at a flat rate of 39%. (Using this method requires agreement between the employer and the employee.)
- **PAYE.** Contributions can be added to salary or wages, and taxed through the pay-as-you-earn (PAYE) system. (This method requires agreement between the employer and employee.)

2.2 The progressive scale was introduced on 1 April 2004 owing to concerns that some employees could be overtaxed on their employer superannuation contributions. Until then, employees earning less than \$38,000 salary could be taxed at 33% on their employer superannuation contributions. Using the progressive scale enables those earning less than \$38,000 salary or wages to pay SSCWT at a rate that is aligned with the tax rate on their salary or wages.

- 2.3 On 1 April 2000, the top personal income tax rate was increased to 39% while the top SSCWT rate remained unchanged (at 33% under the flat 33% rate method). In the same year, a fund withdrawal tax (FWT) was introduced to counter avoidance. The same top rate of 33% was used for the progressive scale method when it was introduced, in 2004.
- 2.4 FWT applies if employer contributions are withdrawn early and has the effect of increasing the effective tax rate on withdrawals by 5%. There are a number of exemptions from FWT, which means that not all early withdrawals of employer superannuation contributions are subject to it.

3. Reducing tax through salary sacrifice

- 3.1 By using the progressive scale, employees who sacrifice salary in return for increased employer superannuation contributions can reduce their overall tax. Some reduction in tax by using salary sacrifice has been possible since 1 April 2000, when a new top personal tax rate of 39% was introduced, but the top rate of SSCWT remained at 33%. However, since 1 April 2004, when the progressive scale was introduced, some employees have been able to achieve significant reductions in their tax by using the progressive scale to calculate SSCWT. This has led to some employees rearranging their affairs in order to minimise their tax rather than using employer superannuation contributions as a mechanism for retirement savings. This creates pressure on the integrity, fairness and efficiency of the tax system.

Example 1: Extreme salary sacrifice under the progressive scale

John earns \$100,000 a year in salary. Income tax on his salary is \$30,270. John makes an arrangement with his employer so that his salary is cut to \$9,500, and the balance of \$90,500 is paid as employer superannuation contributions.

In the first year of this arrangement, John will pay \$1,425 income tax on his salary. His SSCWT rate will be 33%, based on his previous year's salary, so he will pay \$29,865 SSCWT ($\$90,500 * .33$). His total tax liability will be \$31,290.

In the second year, John will again pay \$1,425 income tax on his salary. However, his SSCWT rate will drop to 15%, so he will pay \$13,575 SSCWT ($\$90,500 * .15$). His total tax liability will be \$15,000.

Over the first two years of the arrangement, John's tax liability will be \$14,250 less than it would have been if he had received all his remuneration as salary.

- 3.2 Although some degree of salary sacrifice can form part of usual employment arrangements, it is sometimes used merely to reduce tax, which can create unfairness between taxpayers. Use of extreme salary sacrifice schemes can result in some employees paying less tax than others who earn the same or less income.
- 3.3 Some salary sacrifice schemes entail employees reducing their salaries to very low levels, which means they will need another means of support. Therefore reducing tax through salary sacrifice is likely to be available only to employees who have large assets or income from other sources or who are supported by someone else.

- 3.4 If enough people engage in salary sacrifice, there could be significant erosion of the Crown’s tax revenue base, which could lead to upward pressure on other taxes, thereby increasing the tax burden on other taxpayers.

Suggested amendment to the progressive scale

- 3.5 Extreme salary sacrifice could be minimised by determining SSCWT rates under the progressive scale by the total of salary or wages and employer superannuation contributions, instead of basing rates on salary or wages alone. At the same time, the SSCWT thresholds could be increased by 15% over the corresponding effective income tax thresholds, to minimise the possibility of over taxation. Available data suggest that most employer superannuation contributions are equivalent to 15% or less of salary or wages.
- 3.6 Under the suggested changes, the new thresholds would be:

Threshold:	SSCWT rate:
Salary or wages plus superannuation contributions up to \$10,925:	15% on all contributions
Salary or wages plus superannuation contributions from \$10,926 to \$43,700:	21% on all contributions
Salary or wages plus employer superannuation contributions over \$43,700:	33% on all contributions

Example 2: SSCWT based on salary or wages and superannuation contributions, and thresholds 15% higher than the corresponding effective income tax thresholds

Kylie earns \$36,000 salary, and also receives \$3,600 employer superannuation contributions. Under the suggested changes to the SSCWT thresholds and rates, her SSCWT rate will be 21%, and she will pay \$756 SSCWT.

- 3.7 If the thresholds were not adjusted upwards, some employees could be overtaxed on their employer superannuation contributions if those contributions took them over a SSCWT threshold.

Example 3: Overtaxation when SSCWT is based on salary or wages and superannuation contributions, and thresholds are the same as the effective income tax thresholds

Hemi earns \$36,000 salary, and also receives \$3,600 employer superannuation contributions. If SSCWT rates are determined by the total of salary or wages and employer superannuation contributions, and thresholds are equivalent to income tax thresholds, his SSCWT rate would be 33%, and he would pay \$1,188 SSCWT. Had he received those superannuation contributions as salary or wages, \$2,000 of them would have been taxed at the lower effective rate of 21%. He is overtaxed by \$240 on his employer superannuation contributions.

- 3.8 Basing SSCWT rates on the total of salary or wages and employer superannuation contributions, and setting the thresholds 15% higher than the corresponding income tax thresholds would resolve the problem of extreme salary sacrifice. At the same time it would ensure that employer superannuation contributions are not overtaxed in comparison to salary or wages.

Example 4: Extreme salary sacrifice under the amended progressive scale

John, from example 1, earns \$100,000 a year in salary. Income tax on his salary is \$30,270. John makes an arrangement with his employer, so that his salary is cut to \$9,500, and the balance of \$90,500 is paid as employer superannuation contributions.

In each year of this arrangement, John will pay \$1,425 income tax on his salary. His SSCWT rate will be 33%, based on his combined salary and superannuation contributions of \$100,000, so he will pay \$29,865 SSCWT ($\$90,500 \times .33$). His total tax liability will be \$31,290.

Every year, John's tax liability will be \$1,020 higher than it would have been had he received all his remuneration as salary.

Instead of using extreme salary sacrifice, John can continue to save for his retirement through making contributions himself from his tax-paid salary. These personal contributions are not subject to any further tax. Any employer superannuation contributions will be taxed at 33%, and provided that they do not exceed a certain proportion of his salary, John's overall tax liability will not exceed the amount of tax he would have paid if all his remuneration was received as salary.

- 3.9 Instead of amending the progressive scale, employer superannuation contributions could be taxed as part of wages and salary. However, this approach would have implications for the social assistance received by some taxpayers. Our preferred approach is to ensure that employer superannuation contributions are taxed at more or less the right rate, and employees' entitlements to social assistance are not affected.
- 3.10 We invite feedback on our suggested changes to the progressive scale. We are particularly interested in whether the proposed uplift of the SSCWT thresholds would be sufficient to ensure that most employees are not overtaxed on their employer superannuation contributions.

4. Reducing complexity

- 4.1 As described earlier, there are now four methods that can be used for calculating tax on employer superannuation contributions. These methods have been introduced over time, in response to particular needs and issues. Increasing the number of methods available for calculating SSCWT has added to the complexity to the SSCWT rules.
- 4.2 Of the four methods of calculating tax on employer superannuation contributions, we understand that two are not being used. Available evidence suggests that neither the flat rate of 39% nor the PAYE method is used.
- 4.3 The flat rate of 39% and the PAYE methods of calculating tax on employer superannuation contributions could be removed, in order to make the SSCWT rules less complex. It should be noted that the 39% method was introduced to provide a mechanism for employees to avoid the fund withdrawal tax.
- 4.4 We invite feedback on this proposal. In particular, we would like feedback on whether these methods should be retained, and if so, why.