Tax Working Group Public Submissions Information Release

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To the Tax Working Group

Submission: Future of Tax

This submission is from the Financial Services Council of New Zealand Incorporated (**FSC**) to the Tax Working Group on the Future of Tax.

The FSC represents New Zealand's financial services industry having 33 members at 31 March 2018. Companies represented in the FSC include the major insurers in life, disability, income, and trauma insurance, and some fund managers and KiwiSaver providers plus law firms, audit firms, and other providers to the financial services sector.

Our submission has been developed through consultation with FSC members, and represents the views of our members and our industry. We acknowledge the time and input of our members in contributing to this submission.

The FSC's guiding vision is to be the voice of New Zealand's financial services industry and we strongly support initiatives that are designed to deliver:

1. Strong and sustainable consumer outcomes;
2. Sustainability of the financial services sector; and
3. Increasing professionalism and trust of the industry.

Executive summary
We welcome the opportunity to submit on whether the tax system should encourage saving for retirement and provide suggestions on how this could be achieved. Given the focus of the FSC on growing and protecting the wealth of New Zealanders, our submission is centred around the question on Retirement Savings: *Should the tax system encourage saving for retirement as a goal in its own right? If so, what changes would you suggest to achieve this goal?*

The FSC believes that the tax system should encourage saving for retirement. The FSC would therefore support any recommendations of the Tax Working Group that both encourage greater savings and/or provide a “level playing field” for investments that will encourage diversification of investments (including retirement savings) by individual investors.

The FSC considers that the most viable options to encourage retirement savings that best fit within the current “Taxed Taxed Exempt” tax policy setting, and which could be implemented relatively easily, are:

1. provide lower PIR tax rates across all PIR bands for all PIE funds; or

2. at a minimum, provide lower PIR tax rates for locked-in savings such as KiwiSaver and similar locked-in superannuation schemes (including wholesale PIEs). Ideally lower PIR tax rates could be based on a proportion of the appropriate marginal tax rate of each individual scheme member, for example, reducing existing PIR rates for these products by a further 5% to say 5.5%, 12.5% and 23%.

3. Remove or reduce the rate of Employer Superannuation Contribution Tax (ESCT) that applies to employer contributions, or if a more targeted approach was preferred because of fiscal cost, limit ESCT relief to below a certain threshold, say $48,000, to assist the growth of retirement savings of lower income earners.

The FSC believes that it is important that the tax policy settings are appropriate to encourage New Zealanders to save for their retirement, and that those settings complement the broader retirement policy settings (and are not necessarily done in isolation).

I can be contacted on [1] to discuss any element of our submission.

Yours sincerely

Richard Klipin

Chief Executive Officer, Financial Services Council

Introduction

Our research shows that a very real concern for New Zealanders is whether they will be able to have a comfortable retirement financially. This research also shows that New Zealanders are under-prepared for retirement[1]. It is forecast that there is a $218 average after tax weekly gap between what the retired need to live comfortably and what they actually have. For many, this gap may well be larger especially if they still have a mortgage or are renting. In the FSC's view, this highlights to those still working the importance of making the most of opportunities to grow their wealth and increase their sources of retirement income.

We do not believe that New Zealand Superannuation will be enough to facilitate the high level of living standards that New Zealanders expect during retirement. This puts the onus on private retirement savings to bridge the income gap during retirement.

The FSC believes that the taxation of savings forms an important part of the overall retirement puzzle. Therefore, it will be important that the tax policy settings encourage New Zealanders to save for their retirement, and that those settings complement the broader retirement policy settings (and are not necessarily done in isolation).

We therefore welcome the opportunity to submit on whether the tax system should encourage saving for retirement and provide suggestions on how this could be achieved.

Should the tax system encourage saving for retirement as a goal in its own right? If so, what changes would you suggest to achieve this goal?

Broadly, New Zealand follows a "Taxed Taxed Exempt" (TTE) approach to the taxation of savings. This means that savings are generally funded out of post tax income (T), returns on savings are taxed (T) and withdrawals of savings are tax free (E). This does however place considerable importance on ensuring that the current tax system, while not providing concessions for retirement savings, does not go beyond that and penalise retirement savings due to tax applying to savings as they accrue or distort decisions between different forms of savings.

The strategic issue is therefore to have all savings taxed to an equal extent but, if this is not possible, to remove or at least reduce tax disincentives on accumulating savings so that savings are not directed by the tax system away from financial assets (e.g. bank deposits, government bonds, equities, managed investment schemes such as KiwiSaver). How our tax system impacts on the accumulated investment income of retirement savings is therefore critical for determining the level of retirement income New Zealanders can expect in the future.

The quality of savings in New Zealand has been historically recognised as a problem. New Zealanders have traditionally put a large proportion of their savings into residential property. The reasons behind that may be entirely rational, taking into account the bad experiences as a result of investment fads, the stock market crash in the 1980s, the dot com collapse in the 1990s and the global financial crisis that saw the collapse of many finance companies. However,

[1] Great Expectations: Research conducted for the FSC, December 2017

investment that increases the cost of residential property contributes nothing to the productive growth of the country.

The current tax policy settings encourage the over-investment in land (residential property) and under-saving by way of financial assets. This has adverse impacts on retirement and housing policy and also results in our relatively low level of savings being put to relatively unproductive use.

Further, even without an increase in the overall level of national savings, policy changes that redirect savings into financial assets such as KiwiSaver in our view would improve the quality of investments and facilitate investment in the productive areas of the economy.

In order to achieve a more level playing field, either investments currently receiving favourable tax treatment will need to be taxed more, or those investments currently disadvantaged taxed less. In reality, it is likely that a mixture of approaches will be required to achieve an optimal outcome. From a compliance perspective, maintaining simple rules with broad application should be encouraged with any changes recommended.

The FSC therefore supports any recommendations of the Tax Working Group that both encourage greater savings and provide a "level playing field" for investments that will encourage diversification of investments (including retirement savings) by individual investors. This should also provide social and fiscal benefits to the New Zealand economy over the longer term, such as a significant enlargement and deepening of our financial system with knock-on effects for firm growth and productivity.

At a minimum, the FSC recommend a move towards a ttE type system be evaluated for locked in savings such as KiwiSaver i.e. tax contributions (the first 't') and the savings income (the second 't') at lower tax rates. Given a substantial portion of locked in retirement savings are now managed through portfolio investment entities (PIEs), this outcome could be achieved through an across the board reduction in the tax rates that apply to locked-in PIEs such as KiwiSaver.

Tax barriers to retirement savings

The FSC published a report in 2013 titled "The tax barriers to retirement prosperity in New Zealand" which considered how our current tax rules affect savings, retirement provision and New Zealand's overall economy[2]. The report also outlined a number of options that could be considered to reduce these barriers. A copy of the paper is attached to this submission.

[2] The 2013 Paper was produced with the assistance of Paul Mersi (a former tax partner of PricewaterhouseCoopers and a member of the Savings Working Group), and Robin Oliver MNZM (a former Deputy Commissioner of Inland Revenue in charge of tax policy) and modelling work done for FSC by EY, with the particular input of Peter Goss (Director, Transaction Advisory Services) and Aaron Quintal (Director, Tax) and Blair Tomblin (Senior Consultant, Tax) who was with IRD Policy Advice Division. The Paper has been reviewed by Professor John Piggott of the University of New South Wales and a member of the Henry Review in Australia and the modelling work has been reviewed by John Savage a former NZIER Senior Economist.

The key findings of the report were:

1. that tax changes are necessary to remove the tax barriers in the current tax rules, which heavily discriminate against savings in financial assets.

2. No other country has our combination of comprehensive taxation of the return on debt instruments as they accrue, no superannuation tax concessions, no tax on capital gains on rental properties, and the unconstrained deductibility of the nominal value of interest against other income on debt used to purchase rental property.

3. For most people their first priority is likely to be paying off the home mortgage and then meeting their retirement savings target by building up investments. In New Zealand this is likely to be a KiwiSaver scheme. However, New Zealanders are not saving enough in this way and our current tax rules are a major reason for this.

4. Our tax rules heavily discriminate against savings in financial assets (whether directly or via KiwiSaver or other types of funds) relative to investing in home ownership. For example:

    a. For a home owner every dollar used to repay the mortgage reduces mortgage interest costs that are non-deductible and have to be paid out of after-tax wages. The return on an investment in mortgage repayments is thus totally tax-free. Being a tax-free investment the tax benefit or subsidy is equal to the total equity investment in the home times the income a person would get from investing this money in, for example a bank account, times the person's marginal tax rate.
    b. Ownership of rental accommodation was also tax favoured but to a lesser extent as noted by the Savings Working Group report in 2011, largely due to the non-taxation of capital gains and the ability to deduct the inflation component of interest costs against other income.
    c. By contrast, an investment in say debt instruments such as a bank term deposit was tax penalised with an effective tax rate up to almost 50%[3]. What this means is that people need to save almost twice as much when investing savings in financial assets such as KiwiSaver in order to generate the same income as investing in home ownership.

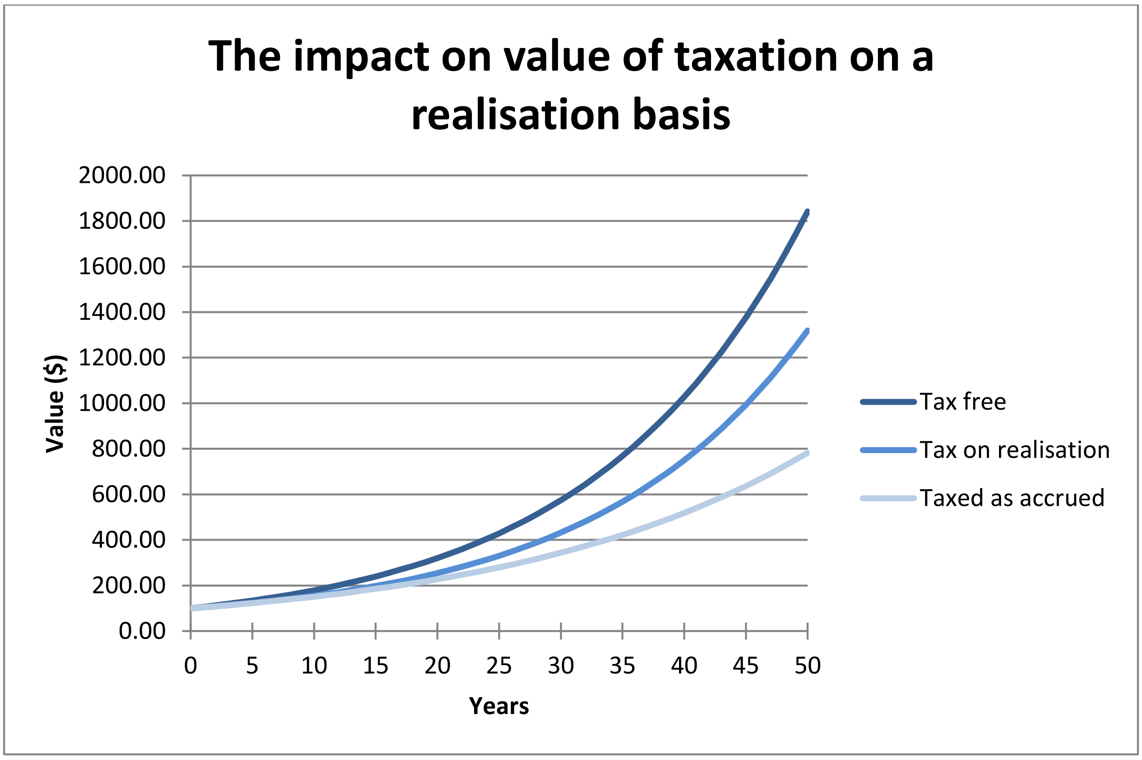
These findings are consistent with the analysis in the Future of Tax background paper on pages 39-40 which clearly illustrates the issue of different types of savings being taxed at significantly different effective tax rates. As the background paper notes, there should be

[3] Pg8, The tax barrier to retirement prosperity in New Zealand. The real effective tax rate was calculated as the tax rate on the nominal return as a percentage of the real return. For example, regarding interest income on a bank term deposit a person pays tax on the 6% nominal return at 33% and inflation of 2%. The tax liability of 1.98% (being 33% times 6%) is calculated as a proportion of the real return of 4%. The real effective tax rate on a bank account term deposit of 49.20%, calculated as 1.98%/4%.

only minor (or no) differences in the tax treatment of different forms of investments if our broad base, low rate system is working well.

5. When it comes to accumulating savings, whether tax is levied each year as income accrues (the tax treatment of KiwiSaver and bank term deposits) versus taxing only when the savings are withdrawn (the tax treatment of a property taxed on gains when it is sold) made a big difference to the eventual post-tax saving fund, the longer the savings accumulate.

   This simply reflects the importance of compounding interest in building up a substantial fund of savings over time. This is demonstrated in the following graph. This shows how an initial $100 deposit grows over 50 years to $1,842 if untaxed, $1,319 if taxed only when withdrawn and only $782 if taxed annually on an accrual basis. In other words, in this example, taxing the deposit earnings reduces its value to the saver by about one third but taxing those earnings as they accrue year by year reduces the savings by 57%.



Assumptions: nominal return of 6%, marginal tax rate of 30%. $100 is invested for up to 50 years.

6. A high tax rate on KiwiSaver investments has consequences for the level of private retirement savings in New Zealand. The real effective tax rate impact becomes higher the earlier a person starts saving for their retirement in KiwiSaver. This is due, in large part to the taxation of the inflation component of investment returns. As a consequence, a person would effectively be incentivised to delay saving for their retirement until a later time, thereby reducing the real effective tax rate impact on their KiwiSaver investment but greatly increasing the amount of contributions needing to be made annually in order to have enough savings for a comfortable retirement.

Saving a little for a long time is therefore not a tax effective retirement savings strategy for New Zealanders but saving over a shorter time period is generally unaffordable.

This tax bias against financial assets used to build up a retirement fund matters. It penalises such savings and makes it hard for people to save to meet their retirement objective. It also encourages people to invest in housing not financial assets such as KiwiSaver.

It therefore should also not come as a surprise that most New Zealanders do not think they are saving enough to fund the sort of retirement they want. The need to address the tax treatment of savings is often seen as an issue relevant to our level of retirement provision. In part that is the case, but it is only part of the story. It needs to be addressed not only as part of sensible retirement income policy but also if New Zealand is to meet our economic expectations as a country.

What is the appropriate model to tax retirement savings – TTE, TET, EET or something else?

The largest cost by far borne by those saving for retirement is the taxation of the return on savings (the middle "T"). The effect of taxation can be to reduce a person's private retirement income on a given level of savings by almost half. That is especially the case with long term or accumulating savings where savings are made over time and the return is reinvested each year in the instrument or savings fund.

The issue of the appropriate tax policy settings for savings is therefore critical for the ability of people to provide a comfortable retirement income by saving a relatively small proportion of their income throughout their working years (saving a little for a long time).

However, the options for change are not easy. A modest and realistic objective is to recognise that home ownership will remain the priority for most people. Therefore, the FSC believes that we should ensure that the tax system provides a level playing field with respect to how people invest their discretionary savings over and above their home ownership needs. This requires a more even or neutral tax treatment of savings for retirement in financial assets compared with the tax treatment of investments in rental accommodation.

New Zealand adopted its TTE basis for taxing retirement income in 1988 and is one of a few countries within the OECD that uses a TTE basis (although we note that Australia does have a concessionary tax rate applied to superannuation scheme earnings).

OECD research published in July 2017 noted countries encourage saving for retirement by taxing retirement savings in private pension plans differently to savings in alternative plans or offering other financial incentives. This is consistent with evidence that suggests tax can have a very significant impact on how people save and invest. This research noted around half of OECD and EU countries apply a variant of EET to retirement savings (refer figure 1)[4].

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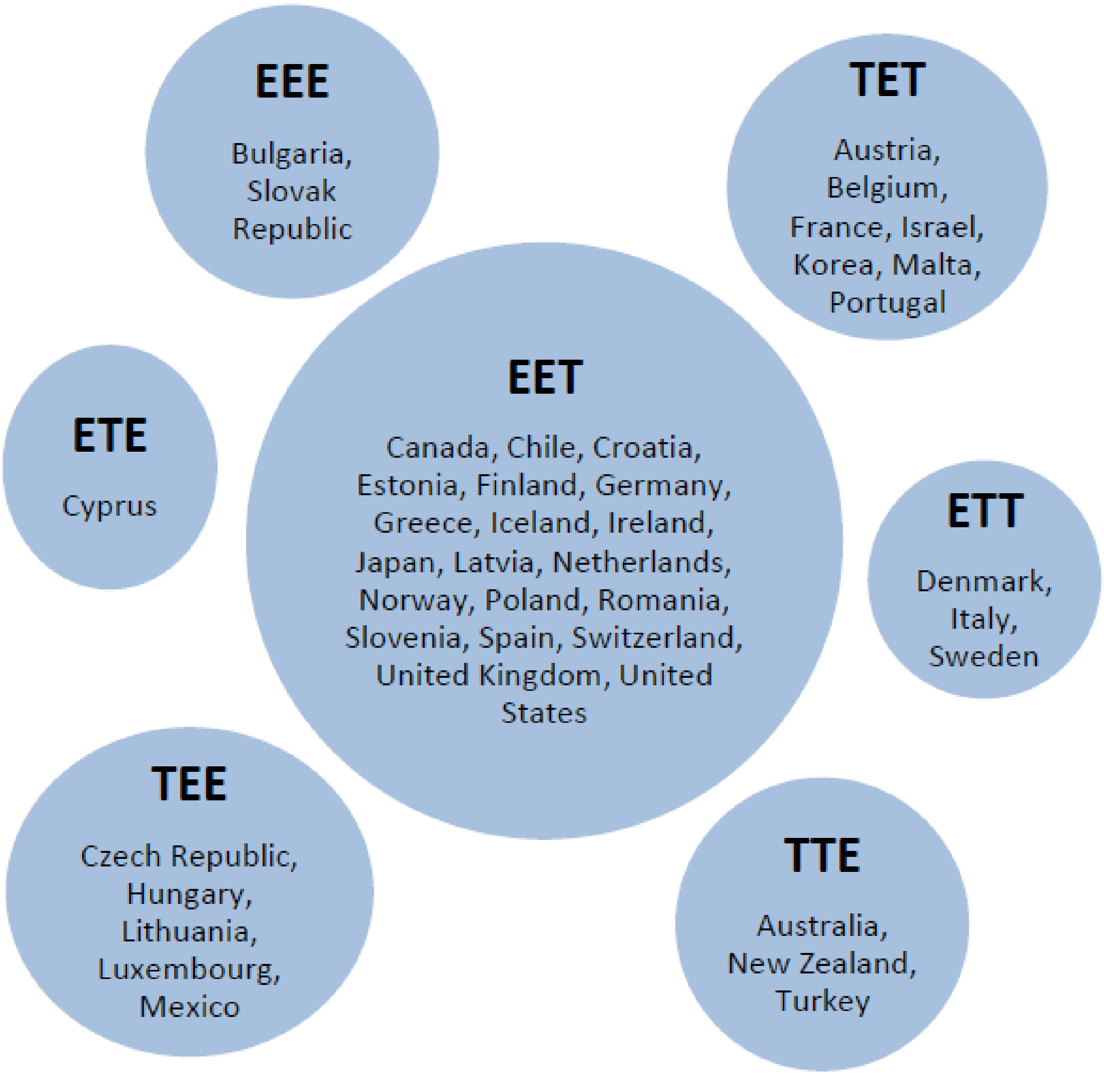
[4] Tax treatment of Retirement Savings in private pension plans across OECD countries, July 2017

Figure 1. Tax treatment of retirement savings in private pension plans



Note: Main pension plan in each country.
Source: OECD (2015), Stocktaking of the tax treatment of funded private pension plans in OECD and EU countries.

Past research has supported an EET regime increasing both personal retirement income and total tax revenue over a life time given the compounding effect gross investment returns has on the accumulated lump sum at retirement. It would also provide encouragement to continue saving in retirement and broadens the tax base in retirement when the retired make demands on public services such as health.

The FSC acknowledges the fiscal cost of an EET regime during transition and also how it interacts with the current National Superannuation settings. For that reason, we have considered alternatives that would not present the same fiscal cost.

Potential options under TTE approach

The FSC's 2013 report outlined a number of possible responses to level the playing field for investment in financial assets, including setting out the advantages and disadvantages of each option. We have not sought to repeat the analysis completed of the options in this submission, but it can be found in pages 26 to 28 (land and residential property) and 34 to 40 (savings) of that report. The options for reform are not necessarily mutually exclusive but instead a portfolio of options could be pursued.

The FSC considers that the most viable options to encourage retirement savings that best fit within the current TTE tax policy setting, and which could be implemented relatively easily, would be as follows:

1. provide lower PIR tax rates across all PIR bands for all PIE funds or

2. at a minimum, provide lower PIR tax rates on locked-in savings such as KiwiSaver and similar locked-in superannuation schemes (including wholesale PIEs). Ideally a lower PIR tax rates could be based on a proportion of the appropriate marginal tax rate of each individual scheme member[5], for example, reducing existing PIR rates for these products by further 5% to say 5.5%, 12.5% and 23%.

3. Remove or reduce the rate of Employer Superannuation Contribution Tax (ESCT) that applies to employer contributions, or if a more targeted approach was preferred because of fiscal constraints, limit ESCT relief to below a certain threshold, say $48,000, to assist the growth of retirement savings of lower income earners.

We believe that a much lower tax rate on investments in financial assets or KiwiSaver-type schemes, would also encourage more people to save for their retirement from an earlier stage of life. This is critical to ensure that New Zealand builds a solid economy for the future with people having a comfortable standard of living in their retirement years.

We acknowledge that any reduction to the tax rate on financial assets or KiwiSaver-type schemes would have a fiscal cost, although this cost could be offset by changes in other policy settings that are recommended by the Tax Working Group. However, if necessary, part of any fiscal cost could be met by redirecting the current government funded incentives for KiwiSaver (the annual member tax credit) to reduce the fiscal impact. However, this approach would need to be considered in the context of the Governments' wider retirement policy settings and other incentives that the Government may be considering outside the tax system.

[5] The FSC's 2013 report estimated that, to create a level playing field for say KiwiSaver funds with an investment in rental property, on reasonable assumptions, the highest tax rate on savings in a KiwiSaver scheme needs to be substantially lowered from the current 28% to 1% assuming that the alternative investment to KiwiSaver is an investment in rental property that is 80% geared and is held for twenty years until sold. The recent changes to introduce a 5 year bright line test and proposal to ring fence rental losses will partially level the playing field, but we still believe that there is scope for lower tax rates to achieve a more neutral outcome.

Real vs nominal gains

Given our comments above about relief for the taxation of retirement earnings given the powerful impact it has on the growth of retirement savings, we do need to comment on taxing real vs nominal gains particularly if the Tax Working Group do recommend to the Government introducing a Capital Gains Tax.

Tax should only be levied on real gains, not nominal gains so there is no taxation of gains which are solely attributable to inflation. Given the difficulty in applying this, in practice, nominal gains are taxed.

Taxing nominal gains is an issue, especially in a low interest rate environment. As noted in the Tax Working Group Background Paper, "As nominal income is fully taxed (that is, income including the inflation component), a 33% tax on the nominal return (that is, the real return plus inflation) on savings in a bank account is actually a materially higher tax on the real return.[6]"

Income from capital should be taxed on a real basis as opposed to a nominal basis, both in relation to taxation on dividends and taxation on interest. These issues are even more significant in the context of how a newly introduced capital gains tax would apply to property that has been held for a number of years, discussed further below.

For capital income where the tax is levied relatively close to the time of its derivation over a short period, inflation can be considered as immaterial. For assets held over a longer term the effects of inflation will be significant, which necessitates some form of allowance to attempt to minimise the taxation of inflation created gains.

There are a number of options to account for inflation.

There is a Risk-Free-Return-Method which makes an annual adjustment for inflation which can be set at a rate based on real returns on capital. This option accurately allows for adjustments for the effect of inflation.

Another option would be to adopt some form of indexation. While indexation should be more accurate than a taper (discussed below), it would also be more complex. Australia previously had an indexation system but this was replaced in 1999 with tax relief. The UK has also changed indexation both for individuals and, more recently, companies.

This then brings us to taper relief. Many countries have taper relief where the amount of the capital gain on which tax is levied decreases or is eliminated if the asset is held for a certain period. In Australia assets held for over a year qualify for a partial exemption from Australian CGT (a 50% discount for individuals and trusts and 33.33% for complying superannuation entities). Holding period thresholds for taper relief vary significant across countries, for example Australia and the USA have a one year minimum holding period whereas Germany has a 10 year minimum period and France a minimum of 30 years.

6 Tax Working Group, Future of Tax: Submissions Background Paper (March 2018), p39.

An option would be a taper system with a scale of different rates. For example, an asset held for five years might qualify for say a 10% discount CGT rate and an asset held for 10 years might qualify for say a 25% discount CGT rate. This would allow the taper to more accurately reflect the trend of inflation over time. The taper could be periodically reset approximating to inflation outturns over the holding period.

Retention of capital gains exemption – PIE funds

If a capital gains tax is recommended by the Tax Working Group, given our comments above on growing private retirement savings, the FSC would strongly advocate that the current tax exemption relating to capital gains on Australasian shares be retained for all PIEs. This recognises that many retail funds including KiwiSaver funds invest into wholesale PIEs to obtain their investment exposures.

FIF rules

The existing FIF rules (i.e. fair dividend method, comparative value method) would also need to be modified if a capital gains tax is recommended by the Tax Working Group to ensure double taxation does not arise.

Land tax

The introduction of a land tax is likely to have a wider impact than just those investments which are the target of the reform. However, any exemptions to narrow the effect of the tax (such as excluding the land under the family home) is likely to reduce the efficiencies of such a regime and its ability to generate taxation revenue. Given the overall impact of the regime would have on the asset bases and balance sheets of the country and individual businesses, we consider that a land tax is not a preferred option.

Savings in retirement

The market for post-retirement products in New Zealand is an opportunity and the industry is looking at ways to provide products such as annuities. The FSC supports an active annuities market (i.e. retirement investment and drawdown options for consumers once their retirement funds become available to them). We believe that such a market would help New Zealanders make the most of their KiwiSaver and retirement savings and help people achieve the level of retirement they want.

However, the current tax settings potentially over-tax annuitants because annuity earnings are taxed at the corporate tax rate of the annuity issuer (often 28%). Tax rate data previously distributed by Inland Revenue shows the tax rates of a high proportion of those aged over 65 (the likely group of annuitants) is likely to be in the current 10.5% or 17.5% rate categories.

We recommend the Tax Working Group consider a similar approach to Australia, where neither annuities or annuity accumulation are taxed.

GST Framework

The FSC's members have to work with the GST boundary between taxable supplies and exempt financial services. This is one of the most complicated areas of the GST rules. It also has the potential to create cascades of tax due to non-recoverable GST relating to exempt supplies being suffered at different points in the value chain. This means the effect of the GST is not transparent to those investors who actually bear the cost.

Of particular concern is the "in source" bias created by GST. As GST does not apply to salary and wages, there is a bias to having services provided by employees rather than third parties whose services may be GST taxable.

For the industry it is impractical and inefficient to hire employees to undertake work on every fund that they manage, for example, where specialist knowledge or skillsets are required such as managing global equity/fixed interest investment portfolios. Further, the Financial Market Conduct Act 2013 (FMCA) and associated regulations impose particular ways of managing funds.

The inclusion of "arranging financial services" as a financial service in the GST legislation has been helpful to manage the "in source" bias. It allows third party services to be supplied without further cascading of GST, which is ultimately borne by the end consumer, the investor.

However, the definition may no longer be workable in achieving this policy objective due to changes arising from the FMCA and associated regulations and interpretations taken by Inland Revenue which is a current issue that requires remediation.

The possible responses include:

- A review of the financial services definitions to confirm the border is appropriately drawn. A narrow review is currently being considered by Inland Revenue which may resolve some of the problems associated with a taxable/non-taxable boundary.
- A review to consider the appropriate treatment of financial services. The FSC's response considers this further.

The last significant review of financial services and GST was in 2002. Around that time, work was done by Professor Tim Edgar on the appropriate treatment of financial services. The broad conclusion was that GST should not apply as, in brief, there was no consumption but mere flows of money. This work in part supported the policy for the GST B2B zero-rating rules. It was not accepted as supporting a broader zero-rating of financial services.

The FSC considers the zero-rating of financial services is a worthwhile topic of further consideration and that it would be timely for the TWG to support a wider review of GST and financial services. We would therefore recommend that a such a review be part of the on-going work programme recommended by the TWG (as we acknowledge that it is unlikely that the TWG will have time to consider the issue and make recommendations).

Appendix A: The tax barrier to retirement prosperity in New Zealand