

Kiwisaver Changes Announced in Budget

The Budget contained a number of measures designed to increase the attractiveness of KiwiSaver. While tax credits on employee contributions were widely expected, the introduction of compulsory employer contributions was a surprise. This will force many employers to rethink their approach to KiwiSaver, which is far from ideal given how close we are to 1 July 2007, the commencement date of KiwiSaver. Given the tight timeframe, one practical approach for employers is to adopt a staged implementation of their response.

Budget key points

The key elements in the Budget relating to KiwiSaver are as follows:

- A tax credit for members that matches their contributions into a KiwiSaver scheme (or a complying superannuation fund) up to a maximum of \$20 per week (\$1,040 per year) from 1 July 2007.
- Phasing in of compulsory matching employer contributions from 1 per cent of an employee's gross taxable earnings in 2008/09 to 4 per cent by 2011/2012.
- A reduction in the tax rate on superannuation schemes from 33% to 30%, to be consistent with the reduction in the company tax rate.
- A tax credit for employers that reimburses them for their matching each employees contributions into a KiwiSaver scheme (or a complying superannuation fund) up to a maximum of \$20 per week (\$1,040 per year) for each employee from 1 April 2008.

- The removal of the facility for KiwiSaver co-contributions between employers and employees from 1 April 2008. For employees who join KiwiSaver prior to that date, there will be a gradual co-contribution phasing-out over 4 years.
- A Government fee subsidy set at \$40 per member per year.
- The rules for complying funds now include defined benefit and "hybrid" schemes. A complying fund is an existing scheme, or section of a scheme, which meets the contribution and lock-in requirements of KiwiSaver.
- The Budget brought a much bigger focus on complying funds. The tax breaks and tax credits for KiwiSaver schemes also extend to complying funds,
- The problems with the compulsory transfer provisions included in legislation late last year have been addressed, although the Bill containing the relevant clauses has to go through the usual Select Committee process and may not become law for some months.

Value of tax incentives

The cost of the tax incentives over the next 4 years is estimated at \$3.2 billion. The table below compares an investment into an existing scheme with the same investment into a KiwiSaver scheme assuming contributions of 4% from both employee and employer (thus ignoring the phase-in of employer contributions). The relative increase in value is included.

Accumulation and increase from contributing to KiwiSaver scheme									
Salary	Scheme	5 year term		10 year term		20 year term		40 year term	
		\$000		\$000		\$000		\$000	
\$40,000	Standard	16.4		40.5		124.4		602.8	
	KiwiSaver	26.8	64%	60.5	49%	184.2	48%	845.4	40%
\$60,000	Standard	24.6		60.8		186.6		904.2	
	KiwiSaver	36.7	49%	84.8	39%	258.6	39%	1,206.3	33%
\$80,000	Standard	32.8		81.0		248.8		1,205.5	
	KiwiSaver	46.5	42%	109.0	35%	333.1	34%	1,567.3	30%

These figures are based on investment returns of 6.0% p.a. and salary increases of 2.5% p.a.

As an example of the value of KiwiSaver and the tax incentives, for an employee on an income of \$60,000 who saves for 20 years with a matching employer subsidy, their accumulation in a KiwiSaver scheme after 20 years is \$72,000 more than the accumulation in a standard superannuation scheme, a 39% increase.

Compulsory employer contributions

The Budget proposals for compulsory employer contributions as a percentage of taxable earnings are shown below.

As from 1 April	Minimum employee contribution	Minimum employer contribution	Total employee & employer contributions
2008	4	1	5
2009	4	2	6
2010	4	3	7
2011	4	4	8

Where an employer offers an existing scheme to an employee, the employer contribution to the scheme the scheme counts as employer compulsory contributions in respect of that employee where the following conditions apply:

- The scheme was in existence as at 17 May 2007.
- The employee was a scheme member prior to 1 April 2008, or the employee was employed prior to 1 April 2008 under an employment contract that provides access to the scheme.
- The contributions that are to count towards the compulsory amount are fully vested.

Most schemes will not be able to satisfy this last condition without an amendment to the scheme's trust deed.

Employer tax credit

The value of the employer tax credit is illustrated in the table below, which is taken from the IRD Budget releases. In effect it slightly overstates the value to an average employer, but it illustrates that the tax credit does reduce the cost to an employer.

For example:

ABC Company has 30 staff paid between \$35,000 and \$90,000 per annum (15 at \$35,000, 5 at \$45,000, 5 at \$60,000 and 5 at \$90,000), a total wage bill of \$1,500,000. 60 per cent of the staff choose to join KiwiSaver from 1 July 2007 and contribute 4 per cent of their salary each. The direct costs of making these contributions are given in the following table.

Tax year	Matching contributions	Employer tax credit	Net cost	% of total wage bill
2008/09	\$9,000	\$9,000	\$0	0.0
2009/10	\$18,000	\$15,240	\$2,760	0.2
2010/11	\$27,000	\$18,720	\$8,280	0.6
2011/12	\$36,000	\$18,720	\$17,280	1.2

Note that once the full 4% compulsory employer contribution has been phased in, the tax credits will only cover the cost of the employer contribution for employees on salaries of \$26,000 or less.

Because the compulsory employer contributions are paid only in respect of employees who opt into KiwiSaver, employers now face a potential difference in remuneration levels between KiwiSaver members and non-KiwiSaver members, even allowing for the tax credit. Looking further ahead, should the public response to KiwiSaver prove favourable it seems likely that at some stage the compulsory employer contribution will be extended to all employees.

Employers who operate on a total remuneration basis will presumably factor their KiwiSaver obligations into decisions about remuneration increases.

Co-contributions

An approach some employers were considering prior to the Budget was a sharing of contributions, for example 2% by the employee and 2% by the employer in order to meet the minimum employee KiwiSaver contribution of 4% of pay. From 1 April 2008 this will not be possible for new contributors and the employee will need to meet the 4%. Co-contribution arrangements which have been put in place prior to 1 April 2008 will be subject to transitional rules such that the employee contribution moves up to 4% from 1 April 2011. Despite this, there is some attraction in putting a co-contribution arrangement in place prior to 1 April 2008, so that employees can gradually build up their contributions, perhaps from 2% next year up to 4% from 2011.

Employer response

These last-minute changes to KiwiSaver change the relative attractiveness to employers of the various options open to them. These options are looked at in detail below, both for employers with no current superannuation arrangements and for employers with an existing scheme. Each employer and scheme will have its own specific issues, and what follows is an outline of the broad options available.

We note there is a mismatch between the salary definition in most schemes and KiwiSaver, which has contributions expressed as a percentage of total taxable earnings.

Employers with no current superannuation arrangements

Prior to the Budget, the main decision for these employers was whether to choose a preferred provider. The introduction of compulsory employer contributions changes the landscape.

Because the compulsory employer contributions are paid only in respect of employees who opt into KiwiSaver, employers now face a potential difference in remuneration levels between KiwiSaver members and non-KiwiSaver members.

Many employers who were planning to choose a preferred provider were likely to publicise the KiwiSaver scheme and its benefits. Those employers now face the situation where they will incur extra costs in respect of employees who join KiwiSaver. This may change the attitude some employers take towards choosing a preferred provider and publicising the scheme. However, the effectiveness of any action or non-action may be minimal, given the large advertising campaign on KiwiSaver which is due to start at the end of May.

Employers with existing schemes

Before looking at the detailed considerations of benefit design, there are two issues to address:

- whether to, and how to, use the tax credits available to employees and employers, and
- how to avoid employees double-dipping, by getting an existing subsidy plus a compulsory employer subsidy.

The logical response to the first issue is for the existing scheme to become a complying fund, or to somehow integrate the current benefits with a KiwiSaver arrangement. The second issue can be avoided for members of schemes who join prior to 1 April 2008. However, it is an issue for post-1 April joiners and will require amendments to current benefit designs, at least for these people.

There are several categories of employee to consider; current members, post 1 April 2008 joiners and current employees who have not chosen to join the existing scheme.

Exempt schemes

There now seems to be little value in obtaining exempt employer status, because many employees are likely to want to participate in KiwiSaver. An employer with an exempt scheme is not required to auto-enrol new

employees. However, it is likely that many current employees will opt into KiwiSaver given how attractive it now appears, so that the purpose for obtaining exemption is now questionable.

Employers with an existing defined contribution scheme

The changes to KiwiSaver outlined above make it far more attractive for existing schemes to seek complying fund status. Complying funds will enjoy all the tax and other benefits of KiwiSaver, with the exception of the \$1,000 'kick-start' contribution and the \$40 annual fee subsidy.

Employer contributions to existing schemes can only be offset against the required compulsory KiwiSaver contributions if they vest immediately in the member. As the offset only applies in respect of members who join prior to 1 April 2008, one possibility is to have a new minimum benefit equal to the accumulation of required KiwiSaver compulsory contributions being introduced for current members. As the compulsory employer contribution goes from 1% in 2008 to 4% in 2011, this can probably be accommodated by many schemes without any effective increase in employer cost. However, the benefit needs to be introduced to meet the "immediate vesting" test.

Many employers will want to treat existing members and future joiners in a similar way.

While existing employer contributions can count towards the compulsory contribution, the existing employer contributions do not attract the tax credits available in respect of employer contributions to a KiwiSaver scheme or to a complying fund section of an existing scheme

Thus many employers may prefer to direct the first 4% of their contributions (or the appropriate percentage up to 2011) to a KiwiSaver scheme or to a complying fund section of a current scheme rather than to the existing benefit design, in order to obtain the benefit of the tax credit.

Accordingly, the employer may decide to cease subsidising the current benefit design from 1 April 2008 or to reduce the subsidy from that date, only subsidising employee contributions to a KiwiSaver plan or to a complying fund section of the current scheme.

The current benefit design will need to be changed for post-1 April 2008 joiners, because in principle they could 'double dip' and receive two employer contributions – one in the existing scheme and one under a KiwiSaver scheme or in a complying fund.

The likely employer response is to either close the existing scheme to new members from 1 April 2008, or to modify the employer subsidy so that the total cost of the existing scheme and the KiwiSaver scheme or a complying fund section is the same as the current cost of superannuation.

On the basis of the above discussion, there appear to be the following options:

Option 1

Amend the scheme such that both the 4% member and the 4% employer contributions are directed to a complying fund section or to a KiwiSaver account, with the balance of contributions going into the current, non-locked-in section, which can continue to be subject to the present vesting rules etc. Legal advice will be required regarding the feasibility of amending the trust deed to effect this.

Option 2

Two variations to options 1 are first to give the employee the choice as to where the contributions go, but this is less tax-efficient for the employer and carries added administrative complexity and cost. A second variation is to reduce the contribution for new members to the minimum, but then new members would receive a lower subsidy level than current members.

Option 3

Close the scheme to new members and direct future contributions and employees to a KiwiSaver product.

Option 4

Wind up the scheme and address the KiwiSaver obligations separately.

The above discussion is equally valid for schemes which provide defined contribution-style benefits, but which operate on the principle of unallocated funding. There is a minor difference in the way that the offsetting employer contribution is calculated, because the scheme is treated as a defined benefit scheme for the purpose of the calculation.

Many of these schemes are so-called 'hybrid' schemes, having a defined benefit section that is closed and an unallocated defined contribution section that is open to new members. The Budget legislation removes the previous restriction that only allowed fully allocated defined contribution schemes to achieve complying fund status. The discussion below looks at defined benefit schemes, and defined benefit sections of hybrid schemes.

Employers with an existing defined benefit scheme

The considerations for the employer are similar to those discussed above in terms of deciding where to direct future employer contributions. However, the mechanisms for integrating KiwiSaver-style benefits with an existing defined benefit design are different.

Employer contributions to an existing defined benefit scheme can be used to offset the employer's compulsory KiwiSaver contribution requirements, but again we note that the associated tax credit is not available. Again, the employer contributions must vest immediately, so if employer contributions towards the current benefit design are to count, a minimum benefit along the lines of that discussed above needs to be introduced. An actuarial calculation is used to determine the amount by which the employer's compulsory KiwiSaver contribution is reduced. Once again, this only applies in respect of joiners prior to 1 April 2008.

If the employer wants to direct the first 4% of contributions (or the appropriate percentage prior to 2011) to a KiwiSaver plan or a complying fund section in the current scheme, a conceptually simple way to integrate the KiwiSaver accumulation with the current defined benefit design is to retain the current benefit design, then simply subtract the KiwiSaver or complying fund accumulation from the defined benefit at the time it becomes payable. The employer can decide whether to pass on, or share, the value of the tax credit. Other things being equal, benefits of the same value are provided to the employee, but the long-term cost to the employer is reduced to the extent that the employer receives tax credits.

A fairer approach and one which will be more agreeable from the member's perspective would be to increase the benefit by the value of the accumulated member tax credits. Any changes along the lines discussed above need to have legal sign-off, as there are a number of areas of the trust deed that would need to be amended, and could throw up potential obstacles to the amendment.

Other approaches which seem feasible are conversion to a defined contribution scheme, wind-up, and the removal or reduction of future benefit accruals with a re-direction of some or all employer contributions to a KiwiSaver scheme or a complying fund section in the current plan.

Complying fund costs

There are extra costs in becoming a complying fund, in terms of set-up, amending the trust deed and the ongoing extra administrative complexity. There will also be a heavier regulatory regime for complying funds.

Stand-alone schemes versus master trusts

For many small and medium-sized stand alone schemes, the lowest cost option may well be to use the compulsory transfer provisions in the Superannuation Schemes Act to shift the existing scheme into a master trust. The scheme would get complying fund status under the master trust.

However, many stand-alone trust deeds contain clauses which effectively prevent the compulsory transfer provisions being used. In those cases, a normal transfer process would need to be used, which may result in some money "leaking out" of the scheme if members take benefits in cash rather than transferring the money to the new master trust scheme.

Draft legislation to address this problem has been released, but as it needs to go through the usual Select Committee process it may not be passed until later this year.

Timeframe

KiwiSaver starts on 1 July 2007, so there is very little time to get new structures in place. There is no time limit on becoming a complying fund - given that compulsory employer contributions start from 1 April 2008, we expect schemes to move to their new arrangements by that date.

The PIE investment regime comes into effect from 1 October 2007, which in itself is forcing trustees and employers to revisit their superannuation arrangements.

Because of the proximity of 1 July 2007, it is not practical for employers to put their ideal arrangements in place by then. A phased implementation may be appropriate as follows:

- acknowledge that initially from 1 July 2007 the employer will need to auto-enrol employees into KiwiSaver (unless exempt employer status is obtained),
- decide in principle by the end of (say) July the approach to KiwiSaver and the extent of any integration with, and changes to, existing schemes ,
- aim to implement the new arrangements by 1 October 2007 at the earliest, or 1 April 2008 at latest, and
- communicate to staff the approach decided on and the determined implementation date.

The discussion above is general. While it gives an overview of possible responses to KiwiSaver, the right response for a particular employer depends on a number of other facts as well, such as commitment to current benefit arrangements, cost and cultural issues. In seeking advice, employers and trustees should also be mindful of any conflicts of interest their advisers might have, in cases where the adviser's firm is also a KiwiSaver provider.

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For further information please contact:
Bernard Reid Phone (09) 300 7163
Mark Weaver Phone (09) 300 7156
John Melville **Ian Midgley**
 Wellington Phone (04) 499 0277

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