Regulatory Impact Statement

Voluntary Bonding Scheme payments and KiwiSaver requirements

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

The question addressed is whether the KiwiSaver employee and employer contribution requirements should apply to Government payments received under a Voluntary Bonding Scheme (VBS), and if not, how that would be achieved.

We have consulted with the Ministries of Education, Primary Industries and Health. We did not consult with applicants under the VBS in order to limit the potential take-up of KiwiSaver entitlements for VBS payments before the above question could be answered.

The potential number of applicants who will successfully qualify for VBS payments over the next few years is not known; nor is it known how many of those will be KiwiSaver members. Based on payments to date, assumptions have been made that relatively few people are currently affected by this issue, but we believe that numbers will grow as applicants become familiar with the process.

To date, only one round of VBS payments have been made and KiwiSaver contributions have been paid in respect of a small number of these payments. The preferred solution is prospective only and will not affect payments made up until the law is changed.

The options considered do not otherwise impose additional costs on businesses, impair other private property rights, restrict market competition, or reduce the incentives on businesses to innovate and invest, or override fundamental common law principles. The direct impacts are confined to the paying agencies and the VBS recipients.

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STATUS QUO AND PROBLEM DEFINITION

Voluntary Bonding Schemes

1. Voluntary Bonding Scheme (VBS) payments are made to encourage recent graduates to work in hard-to-staff specialities and geographical locations. Currently the schemes apply for doctors, nurses, midwives, teachers and veterinarians. They are administered by the Ministry of Education through Teach NZ, the Ministry of Health through Health Workforce NZ and the Ministry for Primary Industries (referred to as the paying agencies). The scheme details can be found on the websites of the paying agencies.

2. The VBS policy framework is that, besides encouraging specific employment outcomes, the VBS payments are used for the repayment of any student loan balances of successful applicants. This reduces their personal debt quickly, and the Government's student loan debt balance. Only amounts over and above any remaining student loan balance will then be paid out in cash to the successful applicant.

3. VBS payments are taxable income. Inland Revenue has recently indicated that if the applicant is an employee, then the VBS payment is an extra pay under the Income Tax Act 2007 (ITA) as it is made in connection with the applicant's employment. This requires the agency making the payment to withhold PAYE and associated deductions in accordance with the ITA and Tax Administration Act 1994. It also has implications for how the KiwiSaver Act 2006 applies. Therefore, while the applicant does not work directly for the paying agency, the paying agency is deemed to be an employer under the various Inland Revenue Acts.

KiwiSaver

4. The KiwiSaver Act 2006 (KSA) sets out the requirements for KiwiSaver members and their employers. Under the KiwiSaver policy framework, although KiwiSaver remains voluntary, contributions are encouraged in several ways. For example, employees' contributions are facilitated by being deducted directly from their pay (if the employer receives a deduction notice from the member or from Inland Revenue). Employers are required to make compulsory employer contributions if the member is having employee contributions deducted to help boost savings. This requires active steps by employees to enrol as a KiwiSaver member, to decide what proportion of their pay is diverted to their KiwiSaver account, and to inform their employer. Otherwise, voluntary contributions can be made directly to a KiwiSaver provider by the individual. Additional member tax credits and a 'KickStart' contribution are also available from the Government.

5. The KSA definition of wage and salary payments includes an extra pay as defined in the ITA. Therefore, it is now recognised that VBS payments do fall under the KSA and the paying agencies are treated as employers. If the member provides the paying agency with a deduction notice, the agency will be required to deduct employee contributions from the VBS payment. In addition the agency will be obliged to make compulsory employer contributions – currently 2% of gross salary and wages, and increasing to 3% on 1 April 2013.

6. From 1 July 2012, the costs of employer superannuation contributions for state agencies are to be met from the departmental appropriations of those various agencies, rather than being reimbursed from a central fund administered by the State Services Commission (as is currently the case). This reflects that employer superannuation contributions are considered part of normal staff costs for an employer, including public sector employers.

Combined impact

7. The combined impact of these laws is that employees who qualify for the VBS payments and who are KiwiSaver members can choose to provide a deduction notice to the paying agency and trigger KiwiSaver requirements. The paying agency would be required to:

- deduct a specified percentage of the VBS payment for referral to the person's KiwiSaver account instead of their student loan account; and
- pay a KiwiSaver employer contribution. The employer contribution would be met from departmental funding, even though the VBS applicants are not staff members of the paying agency other than in tax law.

8. The application of KiwiSaver requirements to VBS payments results in an unanticipated increase in departmental costs for the paying agencies through employer contributions, an unanticipated increase in KiwiSaver account balances of some VBS applicants, and a lower than anticipated repayment of student loan balances. While the VBS policy intention of retaining graduates in hard-to-staff areas would not be affected, this would effectively increase the total payment through the VBS scheme beyond what was contemplated by Cabinet and beyond the funding provided to the paying agencies for VBS payments.

9. To date, only one round of VBS payments have been made and KiwiSaver contributions have been paid in respect of a small number of these payments.

Question to be addressed

10. The question addressed is whether the KiwiSaver employee and employer contribution requirements should apply to Government payments received under VBS, and if not, how that would be achieved.

OBJECTIVES

11. In answering the question, we are seeking to meet two main objectives:

a) keep the cost of the VBS scheme within original Government parameters; and
b) ensure that VBS is applied to quickly reduce student loan debt balances.

REGULATORY IMPACT ANALYSIS

12. The first question addressed was whether the KiwiSaver employee and employer contribution requirements should apply to VBS payments. Although the potential number of applicants who will successfully qualify for VBS payments over the next few years is not known, nor is it known how many of those will be KiwiSaver members, we expect this to be an increasingly important question. This is because we believe that numbers will grow as applicants become familiar with the process, even though relatively few people are currently affected by this issue.

13. If KiwiSaver contributions are made in respect of VBS payments (the status quo), the objectives would not be met, namely:

- **The cost of the VBS scheme would not be within original Government parameters:** Where a person provides a KiwiSaver deduction notice, the paying agencies would be required to pay a KiwiSaver employer contribution. This would increase the total payment through the VBS scheme beyond the limits agreed by Cabinet and beyond the funding provided to the paying agencies for VBS payments.
- **VBS would not reduce student loan debt balances as quickly:** If KiwiSaver continues to apply, as under current law, it would reduce the amount being provided towards the repayment of student loan balances, as originally intended under the VBS scheme. This would only occur for those applicants who have decided to join KiwiSaver and who decide to provide the deduction notice before payment is made.

14. If KiwiSaver contributions are not made in respect of VBS payments, then the objectives are met.

15. We considered three options for how the objectives could be met, all of which necessarily require legislative change:

a) Make the VBS payments tax-exempt.
b) Change the way VBS payments are taxed, so that paying agencies are not treated as employers under tax law.
c) Exempt the VBS payment from KiwiSaver.

Option (a): Make the VBS payments tax exempt

16. This option is to make the VBS payments tax exempt. This would remove the payment from all tax obligations and also exempt the paying agencies from being treated as an 'employer' and the associated obligations. As a result, the payments would not be considered as an extra pay and would not be subject to the KSA requirements.

17. If the payments were made tax exempt, it is likely that the amount paid to the applicants would be adjusted downwards so that the same "after-tax amount" would be paid (dependant on the specific wording of the agreements of the different agencies). This is because the original Cabinet decision sought to pay amounts under the VBS so that student loans would generally be repaid within a short period of time. The amount was calculated by reference to average student loan balances and salaries for each profession, and on the assumption that the payments would be liable to tax.

18. This option would ensure that the full VBS payment is directed towards repaying the student loan balance, achieving the intention of the VBS policy. There would be no additional costs for the paying agencies arising from KiwiSaver requirements. There may also be a reduction in administration costs for some agencies from no longer having to withhold PAYE. However, other agencies could face an increase in costs as they would no longer be able to use existing payroll systems to make the VBS payment.

19. Making the payments tax exempt would also be contrary to the Government's Revenue Strategy of a broad-base, low-rate tax system that minimises economic distortions. It would also be perceived to be unfair to other taxpayers who are required to pay tax on employment-related earnings. We are aware that other employers also make bonding payments, which are taxable.

20. Making the payments tax exempt would also have a wider impact on other government policies that are income-targeted, such as Working for Families Tax Credits. This would provide unintended benefits to VBS applicants, which may be considered unfair in comparison to other recipients of government assistance. These income-targeted policies could be adjusted to ensure VBS payments continue to count as income for the purposes of those polices, even if they are tax exempt. This would require considerable legislative and regulatory change and associated administrative and systems costs for a wide range of departments. It also risks unintended consequences arising from changing so many pieces of legislation.

Option (b): Change the way VBS payments are taxed so that paying agencies are not treated as employers

21. This option would continue to tax the VBS payments, but not as income from employment. Instead they would be separately defined as taxable income and so would also be caught for the wider range of social policies. The option would remove the PAYE and associated withholding requirements on paying agencies. As a consequence, the KiwiSaver employee/employer contribution rules would not apply as VBS payments would no longer be an extra pay.

22. If the paying agencies are no longer responsible for withholding PAYE, then the responsibility to return and pay any tax due would fall on the recipient of the payments. It increases the compliance costs for individuals and would increase the likelihood that they are required to file tax returns and pay provision tax payments. It also raises risks that tax owing may not be collected or tax collection would be delayed. This increases their exposure to penalty and interest provisions if tax is not paid on time.

23. There would be additional administrative costs for some paying agencies as they would no longer be able to use existing payroll systems to make the VBS payments. This would also require system changes for Inland Revenue and administrative costs to collect the tax. There are also questions over how to direct the after-tax VBS amount towards the student loan balance while ensuring the applicants receive sufficient payment to meet the tax obligations. As a person's tax obligations depend on their total income (and deductions and carry forward losses) for the year, it can be difficult to determine in advance how much tax to set aside from the VBS payment.

Option (c): Exempt the VBS payments from KiwiSaver (preferred option)

24. The third option is to keep the existing tax and social policy treatment, where VBS payments are an extra pay, but to include a new exemption in the KSA to exempt the payments for the purposes of that Act. That is, the definition of extra pay in the KSA would exclude VBS payments. The KSA already provides exemptions for income from certain government payments, such as welfare benefit payments. For example, the Unemployment Benefit is treated as income under the ITA, and the paying agency (Work and Income) is required to withhold PAYE and make returns as an 'employer'. However, they are not required to make KiwiSaver contributions as welfare payments are specifically exempt from the definition of salary and wages under the KSA.

25. This option does not disrupt other income tax or social policy settings. Paying agencies would continue to ensure payments were subject to PAYE and associated deductions and be treated as an extra pay. No systems changes would be required by the paying agencies or by Inland Revenue to administer this KiwiSaver exemption.

26. Because no employee contributions would be deducted, the amount that could be directed to repayment of student loan balances would be maintained; this is consistent with VBS policy. No KiwiSaver employer contributions would be required; this reduces the cost to the paying agencies.

CONSULTATION

27. The Ministries of Health, Education and Primary Industries, which administer the VBS schemes, were consulted as part of the review by Inland Revenue of the tax and social policies implications of the VBS payments. The Ministries provided background information on their VBS schemes, the policy framework and objectives, and how they process and administer the payments. Along with the Treasury, options were then discussed and issues identified. This lead to the identification of preferred options and the recommendations below (which were also discussed with the above Ministries).

28. The Ministries, in particular, provided information on how the various options could impact on the process and costs of administrating the schemes and making payments to applicants. Concerns were raised that there should be a minimal impact on existing processes and that additional unanticipated costs should be avoided or minimised where possible. It was identified as an important objective that the VBS policy continued to be achieved, and that payments not be delayed. Any implementation should not disrupt other government priorities, such as changes to the student loan scheme.

29. We did not consult with applicants in order to limit the potential take-up of KiwiSaver entitlements for VBS payments before the above question could be answered.

CONCLUSIONS AND RECOMMENDATIONS

30. Of the options that were considered, option (c) is preferred. It achieves the key objectives and minimises compliance costs and changes to existing systems and business processes for the paying agencies. It uses an existing approach under the KSA, which limits the possibility of unintended consequences.

31. To date, only one round of VBS payments have been made and KiwiSaver contributions have been paid in respect of a small number of these payments. The change would apply on the date of Royal assent of a legislative change to implement this option. This will avoid complications that arise with retrospective application to payments that have already been made and not interfere with the past decisions of those who have already received payments and made KiwiSaver deductions.

IMPLEMENTATION

32. A change to the KSA will be required to exempt the VBS payments from the definition of extra pay. The change is proposed to be included in the next available taxation bill and apply prospectively from date of Royal assent, and will be implemented immediately. From that date the paying agencies would no longer need to make KiwiSaver deductions and employer contributions from VBS payments. Given that it was not originally anticipated that KiwiSaver requirements would apply to VBS payments, there is no real impact on applicants once the change is enacted; instead they will no longer have the option of receiving an unintended increase in total payments.

33. Inland Revenue provides factsheets on the tax-related treatment of Voluntary Bonding Scheme payments on its website, including KiwiSaver requirements. These will be updated once the legislation has been enacted. The paying agencies regularly provide information to potential and current applicants on the schemes and any changes.

MONITORING, EVALUATION AND REVIEW

34. There are no plans for monitoring and evaluating the change, given the small group that is affected by the legislation. The paying agencies would continue to monitor the overall impact of the schemes.