Regulatory Impact Statement

Mismatch in tax treatment of certain offshore assets and foreign currency hedges

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

The question in this statement is whether the tax rules that apply to certain foreign currency hedges should be changed so that they are effective in removing the impact of foreign currency fluctuations both before and after tax.

There are no significant gaps, assumptions, dependencies, constraints, caveats or uncertainties that have been identified.

In preparing this statement we have discussed the issue and potential options with a broad spectrum of representatives from the fund management industry. This consultation helped define the problem, and develop the options and analysis summarised in this statement. In particular, we discovered that the risks of some options were lower than originally thought and that there would be significant practical difficulties in implementing the solution we initially preferred. This led us to change our preferred option.

We have consulted with the Treasury, which agrees with our analysis.

The proposed change does not impose any new significant compliance costs on affected taxpayers, as taxpayers would be able to choose whether or not to use the proposed optional rule. Consultation has informed us that the compliance costs are minimal for those who choose to use the proposed rule and that the record-keeping requirements align with standard industry processes.

The proposed rule does not impair private property rights, reduce market competition, provide disincentives to innovate and invest or override common law principles.

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STATUS QUO AND PROBLEM DEFINITION

1. When a person invests in an offshore asset, unexpected changes in exchange rates can significantly impact on the value of the person's investment when it is converted back into New Zealand dollars. Investors often enter into foreign exchange hedges, a type of financial arrangement, in order to protect the value of their investment from these currency fluctuations.

2. At present, there is a long-standing tax anomaly for a person who enters into a foreign currency hedge in relation to certain offshore assets. These assets are referred to as "affected assets" in the rest of this statement and comprise assets taxed under the Fair Dividend Rate (FDR) regime and Australian listed shares that are exempt from the Foreign Investment Fund (FIF) rules.[1]

3. The anomaly arises because the affected assets and foreign currency hedges are taxed on a different basis. For example, under FDR changes in an asset's value are not taxed. Instead, FDR assets are taxed on an imputed return of 5% of the asset's market value at the start of the year. Conversely, changes in a hedge's value are fully taxed under the financial arrangement rules. This mismatch in treatment means that a hedge, which is effective in removing the impact of unexpected currency fluctuations before tax, will cease to be effective after tax.

4. The issue is perhaps best illustrated by example. Say a person has an offshore asset portfolio worth $10,000 USD and the NZD/USD exchange rate unexpectedly rises from $0.75 to $0.80. The person's asset portfolio is taxed under the fair dividend rate (FDR) regime. In New Zealand dollars, the portfolio's value falls from $13,333.33 to $12,500.00 NZD. If the person had used a foreign currency hedge to completely remove exchange rate risk, before tax is taken into account, the hedge will increase in value by $833.33 NZD, exactly cancelling the change in their portfolio's value. The hedge is totally effective before-tax.

5. The story is different after-tax. The offshore assets have lost $833.33 NZD of value. However, under FDR no deduction is given for this decrease. Despite this, the $833.33 increase in the hedge's value is taxable. After-tax, the person has lost $833.33 NZD from their asset portfolio but gained only $600.00 NZD from their hedge; the shortfall of $233.33 is created by the tax payment.[2]

6. This mismatch creates numerous issues. First, taxpayers expect hedging to reduce the impact of exchange rate fluctuations on post-tax income. The mismatch results in hedging being less effective. In turn, this fluctuation in investors' after-tax earnings leads to fluctuations in Government tax revenue. Although tax from offshore investment is a relatively small proportion of total tax revenue, solving this mismatch issue would help decrease volatility in this area.

7. We understand that the mismatch is a particular issue for the fund management industry, although it is likely to also be a problem for other types of investors (e.g. companies and individuals).

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[1] These are the main types of foreign asset where the tax mismatch issue arises. The issue may arise with assets taxed under some of the other FIF calculation methods. However, due to the way that these other methods operate, the mismatch is less likely to arise. In addition, it is uncommon for widely-held investment entities to invest in these other types of asset.

[2] In this example, the taxpayer is made worse off due to the tax mismatch. Had the exchange rates moved in the opposite direction the taxpayer would be made better off.

8. Some taxpayers are able to address this mismatch issue by "grossing up" the amount that they hedge. In essence, this involves increasing the amount of foreign currency a taxpayer hedges to take account of their potential extra tax liability that may arise because of the tax mismatch. This approach of grossing up hedges has a number of problems. First, it is very difficult for Portfolio Investment Entities (PIEs), one of the main investment vehicles used in New Zealand, to gross up their hedges because a PIE does not face a single tax rate. Second, even for non-PIE investors, grossing up hedges increases the costs of hedging due to the larger amount of foreign currency that needs to be hedged. Finally, the practice exacerbates fluctuations in Government revenue caused by the tax mismatch.

9. The question in this statement is whether the tax rules that apply to certain foreign currency hedges should be changed so that they are effective in removing the impact of foreign currency fluctuations both before and after tax.

10. There are no clear advantages to keeping the status quo. However, solving this issue potentially carries some risk. Foreign currency hedges are a financial arrangement and taxed under the financial arrangement rules. These rules take a very risk-averse approach to taxation in order to prevent tax planning. Some solutions to the problem (such as options 1 and 2 below) involve removing some foreign currency hedges from the ambit of the financial arrangement rules. This approach could enable tax planning necessitating other base protection measures to be put in place. Another potential risk with options 1 and 2 is that the effective tax rate that would apply to hedges covered by the new calculation method would be lower than the tax rate applying to other financial arrangements. This is not a concern for genuine hedges, which on average have a nil taxable value. However, it would create an incentive for taxpayers to attempt to classify profitable financial arrangements as eligible for the new calculation method.

11. We note that "tax mismatches" can arise in other situations. This statement does not address the mismatches in these other situations. We understand that foreign currency hedges made in relation to affected assets is one of the most common situations where the mismatch occurs; other situations are less so. Moreover, addressing the mismatch for these other situations would have different risks and require different solutions than those considered in this statement.

OBJECTIVES

12. The main objective is to, as much as possible, enable taxpayers to effectively hedge their investments by providing a mechanism that aligns the after-tax change in the value of their foreign currency hedges to the after-tax change in the value of their offshore investment portfolio. A second objective is to minimise the risks of moving away from the status quo.

REGULATORY IMPACT ANALYSIS

13. The options we have identified are:

> *Option 1 (preferred)*: create an optional rule that would allow a taxpayer to calculate the tax on a foreign currency hedge on the same basis as their FDR assets. To reduce the risks of this approach, this rule would be restricted to widely held investment entities and include stringent record-keeping requirements.

Option 2: as in *option 1*, but without rules restricting the type of entity able to use the new rules.

Option 3: facilitate PIEs to gross up hedges by allowing them to use different investors' tax rates to stream the profits (or losses) from foreign currency hedges.

Option 4: retain the status quo.

14. Our preferred option is option 1. It effectively addresses the problem and does so in a manner that is manageable for the managed fund industry. While it does impose costs on the funds that elect to use the new rule, this is not mandatory. For those that elect its use, we have designed the mechanisms of the new rule to ensure compliance costs are minimised. The restrictions on entities able to use the rule and stringent record-keeping requirements ensure there is no undue tax-base risk.

15. Option 1 does not address the tax mismatch problem for non-managed funds (such as companies and individual investors). While option 2 would not have this problem as it applies broadly, it would be a high risk approach. Option 1 covers widely held funds, which have investment mandates and other documents that disclose investment strategies. As a result of this and their size, their activities are also quite visible. These factors limit the risks. In addition, the fact that investors can generally enter and leave managed funds limits the incentive for such entities to take aggressive tax positions.

16. The final reason we prefer option 1 over 2 is that the benefits of the solution are greater for widely held funds. This is because PIEs, a very large part of the managed fund industry, cannot effectively "gross up" their hedges, whereas non-PIE investors can use this approach currently.

17. Before consulting with the fund management industry our preferred option was option 3. From this consultation, we discovered that this option would not be practical. It would very difficult for PIEs to stream the profits or losses arising from a hedge to different investors based on their tax rates. Moreover, it is difficult for a PIE to determine the correct rate to gross up its hedges as many of its large investors (such as companies and other managed funds) will have notified the PIE to tax them at 0%. However, this 0% rate does not necessarily mean that the PIE should not gross up its hedges in respect of these investors.

18. Option 4, maintaining the status quo, is not desirable as is described above. It creates challenges for offshore investors and creates unwelcome volatility in Government revenue.

19. None of these options has a fiscal cost since on average the positive and negative impacts of the tax mismatch net out over time.

CONSULTATION

20. We have discussed this issue and potential options with a broad spectrum of representatives from the fund management industry. This consultation helped define the problem, and develop the options and analysis summarised in this statement. In particular, we discovered that the risks of some options were lower than originally thought and, as noted, there would be significant practical difficulties in implementing the solution we initially preferred. This led us to change our preferred option.

21. We have also consulted with the Treasury, which agrees with our analysis.

CONCLUSIONS AND RECOMMENDATIONS

22. The recommended option is to create a new calculation method that gives widely held managed funds the option of having their eligible foreign currency hedges taxed on the same basis as FDR. Under this option the after-tax changes in the value of a taxpayer's offshore investment portfolio should closely match the after-tax change in the value of their foreign currency hedges. This would eliminate the tax mismatch.

IMPLEMENTATION

23. The necessary legislative changes will be included in the scheduled July 2012 tax bill, applying from the start of the 2013-14 tax year.

24. Implementing this option does not involve any systems changes for Inland Revenue. Updating Inland Revenue's published advice to reflect this change can be managed within standard business-as-usual processes. As a result, no significant systems risks have been identified.

MONITORING, EVALUATION AND REVIEW

25. The adoption and use of this change by the fund management industry will be monitored as part of Inland Revenue's standard tax assurance process. If specific concerns are raised, we would determine if there are substantive grounds for review under the Generic Tax Policy Process. The Income Tax Act 2007 is also subject to regular review by officials.