

# REGULATORY IMPACT STATEMENT

## REMOVING A POTENTIAL TAX BARRIER TO NON-RESIDENT INVESTMENT IN CORPORATE BONDS

### AGENCY DISCLOSURE STATEMENT

This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of options to remove a tax barrier to non-resident investment in New Zealand corporate bonds.

To keep fiscal risks to a manageable level, it is important that any policy change does not undermine New Zealand's ability to tax closely held debt. Several options were rejected after initial policy work determined they would not be feasible to implement or could involve high fiscal costs and risks.

An official's issues paper was published and feedback provided information on the extent of the tax barrier and options for removing the tax barrier to non-resident investment in New Zealand corporate bonds, whilst retaining tax on closely-held debt. In response to this feedback, several changes were made to the design of the options. These changes are detailed in the body of the Regulatory Impact Statement.

Although the recommended approach removes the tax barrier, the extent to which it may lead to an increase in bond market activity is unclear. This is because factors other than tax also influence the investment cost and corporate decision-making in this area. The proposed criteria would also generally exclude "wholesale" bonds (bonds issued to a small number of institutional investors). Wholesale bonds make up over half of New Zealand's existing corporate bonds.

Although the recommended approach does not increase compliance costs for bonds listed on the NZDX (which comprise about 40% of existing corporate bonds), the approach could increase compliance costs for bond issuers who seek to apply the exemption to other bonds. However, bond issuers could still choose to apply the existing rules (i.e. pay AIL of 2%) and would suffer no increase in compliance costs.

The recommended approach does not impair private property rights, restrict market competition, reduce the incentives on businesses to innovate and invest, or override fundamental common law principles.



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## PROBLEM DEFINITION AND STATUS QUO

1. Well-developed domestic capital markets have an important role in relation to economic growth, as they provide increased access to finance for New Zealand firms, capture the benefits of finance arrangements in New Zealand and encourage firms to remain in or move to New Zealand.
2. New Zealand's financial system is split between a large, efficient and sound banking system and lesser developed equity, venture capital and debt markets. As at December 2008, the domestic bond market was the source of about 4 percent of all debt for non-financial businesses. The bulk of business debt was raised through domestic financial institutions (61 percent) and from offshore sources (26 percent from significant stakeholders and 9 percent from others).
3. Although New Zealand's corporate bond market is a relatively minor part of our financial system, it has experienced strong recent growth. Between December 2005 and December 2009, the total value of corporate bonds issued in New Zealand increased from \$14 billion dollars to \$42 billion dollars. Bonds listed on the NZDX increased from \$7.5 billion dollars to \$15.5 billion dollars over the same period.
4. This growth in the corporate bond market is significant given that bond markets have a part to play in well-developed capital markets. Bond markets have a number of important signalling and support roles which affect the performance of the capital markets, and the wider financial system.
5. New Zealand's non-resident withholding tax (NRWT) and approved issuer levy (AIL) rules have been identified by the Reserve Bank and the Capital Market Development Taskforce as a possible tax impediment to the development of New Zealand's corporate bond market. AIL can be paid as an alternative to deducting non-resident withholding tax (NRWT) on interest payments to unrelated non-residents.
6. AIL increases the effective interest rate of bonds issued to non-residents. For example, a non-resident investor who requires a 10 percent return to buy bonds from a New Zealand company would require the company to pay an interest rate of 10% to the investor and a further 0.2% to Inland Revenue, increasing the company's cost of funds.
7. The impact of the NRWT and AIL rules on the domestic bond market could be exacerbated by the fact that it is possible for companies to establish branches and borrow through these branches without paying AIL or (as an alternative) NRWT. On the other hand, interest payments on bonds issued in the domestic market are subject to either AIL or NRWT. This means that issuing bonds on the domestic market may be discouraged relative to issuing debt through a branch or borrowing directly through domestic banks.
8. The problem addressed in this Regulatory Impact Statement is how NRWT and AIL may be removed as a tax barrier to non-resident investment in New Zealand corporate bonds.

## OBJECTIVES

9. The objective is to remove a potential tax barrier to corporates and non-resident investors participating in the New Zealand bond market, but to do this without undermining New Zealand's ability to tax closely held debt (such as loans).

## REGULATORY IMPACT ANALYSIS

### *Rejected options*

10. We considered whether we could level the playing field between domestic bonds and other sources of debt finance by ensuring that AIL or NRWT was always paid on foreign debt. However, there are a variety of ways that foreign debt can escape NRWT, some of which would be difficult to address with tax legislation. In other words, if we tried to implement this option it would be more likely to lead to a shift into other NRWT-free arrangements than a shift into corporate bonds. The new rules could disrupt existing arrangements and lead to extra compliance costs and uncertainty. We concluded that it would not be feasible to effectively implement this option.

11. We also considered whether a zero rate of AIL should apply on all debt instruments between unrelated persons. This could encourage some corporates to increase their overall level of borrowing, by reducing the cost of debt. It is unclear whether it would have any effect on the composition of business debt as the exemption would apply to loans, syndicated loans and private placements as well as bonds.

12. A zero rate of AIL on all forms of unrelated debt would have very high fiscal cost. In addition to the foregone AIL revenues (about \$62m<sup>1</sup> a year), it could encourage some domestic lending activity to shift offshore. In such cases, the margin earned on the loan would no longer be subject to New Zealand tax. This could pose a significant fiscal risk because of the importance of the banking sector to New Zealand's corporate tax base.

13. To some extent, this fiscal risk already exists. Under the current NRWT rules it is already possible for a foreign company to lend directly into New Zealand and pay no NRWT, if it has a branch in New Zealand (although income tax is still payable on the net interest margin). Similarly, a New Zealand company can use an offshore branch to borrow from offshore with no NRWT being payable.

### *Recommended approach*

14. The issues paper focused on how a zero rate of AIL could be designed to apply to qualifying bonds, with AIL still applying at a 2 percent rate on closely held debt (such as bank loans). This approach allows for qualifying criteria to be designed as a way to manage the fiscal risk to the corporate tax base.

<sup>1</sup>Cost includes the fact AIL is deductible from company tax i.e.  $85 \times 0.72 = \$62m$

15. A specific proposal was included in the issues paper. Under the proposal, there were two ways to qualify for the zero rate of AIL. The main test was a stock exchange test, with a widely-held test as a back-up option for publicly traded bonds that are not listed on the NZDX. These tests would be supplemented by several other conditions and exclusions.

16. Following submissions, the proposal was refined into the following set of qualifying criteria. To qualify for the zero rate of AIL a bond would need to:

- a) Either:
  - a. be listed on the NZDX (stock exchange test), or
  - b. alternatively, be issued to at least 100 persons who the issuer could not reasonably expect to be associated with the issuer or each other and not be held by a person who has 10% or more of the total debt securities (widely-held test); and
- b) be "an offer of securities to the public" under the Securities Act 1978; and
- c) Not be issued through a private placement; and
- d) Not be an asset-backed security (e.g. securitised mortgages); and
- e) Be issued in New Zealand (i.e. they have a New Zealand registry and paying agent) and be denominated in New Zealand dollars.

#### *Impact on bond market activity*

17. Although a zero rate of AIL would make bonds a relatively cheaper source of finance, there is uncertainty about the extent to which this would lead to an increase in bond market activity.

18. There is some evidence of an increase in the size of the domestic bond market in Australia following the introduction of a "public offer" test for bond issues in the early 1990s and the growth of funds under management from compulsory superannuation. However, it is difficult to determine the relative impact of either factor.

19. Many factors influence bond issuing decisions besides interest costs. These include a desire to secure larger or longer-term finance, maintain a good credit rating, or access a larger pool or different set of investors.

20. Furthermore, it may be cheaper for firms to issue debt in offshore markets, regardless of the impact of AIL. Compared to the New Zealand bond market, offshore markets can sometimes provide access to more favourable exchange and interest rates, and to a larger pool of investors. This means that banks and other large corporates may continue to raise much of their debt offshore if AIL were zero-rated, rather than issue new bonds into the New Zealand market.

21. Submissions on the consultation paper expressed concern that many existing corporate bonds would not qualify for the zero rate of AIL. In general, wholesale bonds (bonds issued to a small number of institutional investors) will not satisfy the

proposed qualifying criteria and will continue to face a 2% rate of AIL. Wholesale bonds make up over half of New Zealand's existing corporate bonds. It would be difficult to design a measure that accommodated wholesale bonds but which excluded bonds that were, in substance, private placements or syndicated loans.

#### *Fiscal risk / cost*

22. The direct loss of revenue from zero-rating AIL on bonds is estimated to be about \$5 million per annum.

23. There could be a significant risk to the corporate tax base if the zero rate of AIL applied to closely-held debt. The design of the qualifying criteria manages this risk.

#### *Compliance costs*

24. Compared to the existing AIL rules, there would be a small increase in compliance costs for bond issuers that sought to apply the widely-held test where the bonds were not issued on the NZDX. This is because they would need to check that they complied with the requirements of this test (held by 100 persons and less than 10% holding). In most cases the issuer will only have to satisfy the widely-issued test on one occasion - the test would thereafter only need to be re-applied if there was an arrangement that could circumvent the test.

25. There would be no increase in compliance costs for bonds that were listed on the NZDX as these would qualify under the stock exchange test. There would be a small decrease in compliance costs as the issuer would not have to pay AIL to Inland Revenue.

26. As the zero rate of AIL would be optional, there would be no increase in compliance costs for any issuer who chose to continue to pay AIL at 2%.

#### *Social, environmental or cultural impacts*

27. There would be no social, environmental or cultural impacts from adopting the proposal or the alternatives options considered above.

### **CONSULTATION**

28. An exemption from AIL and NRWT on widely-held bonds was considered by the Jobs Summit and by the Capital Market Development Taskforce, and received "in principle" recommendations from both groups. An officials' issues paper was released in September 2009. Fifteen submissions were received from tax practitioners, banks and bond market participants.

29. Submissions on the consultation paper expressed concern that many existing corporate debt issues would not qualify for the zero rate of AIL under the proposed

stock exchange or widely-held tests. Accordingly many submissions sought a looser or wider exemption that would accommodate private placements, syndicated loans and other forms of closely-held debt. However, if this approach were adopted, a similar fiscal risk to having a zero rate of AIL apply to all unrelated debt would be created (see above).

30. Submitters also expressed concern that the requirements of the widely-held test would make qualifying for the zero rate of AIL too difficult and costly for many bond issuers to comply with. Those requirements were that the bonds be issued to at least 100 investors and that no investor held more than 10% of the bonds.

31. In response to this feedback several changes were made to the design of the widely-held test:

- Issuers would be allowed to apply the test to a group of fungible securities (as opposed to applying it to each individual issue). This would accommodate issuers who choose to issue additional tranches of the same bond. It would also allow issuers to gradually build up to 100 investors in their bonds so that bonds that did not initially qualify for the zero rate, may qualify from a later date.
- A requirement to apply the widely-held test each and every year was replaced with an anti-avoidance rule. The widely-held test would only need to be re-applied if a contract was made between the issuer (or a person acting on behalf of the issuer) and another person where that contract could circumvent the test.
- The impact of the 10% threshold was narrowed, so that only the interest paid to those investors with a greater than 10% stake would be disqualified from the zero rate of AIL. Interest payments made to other investors who had a holding of less than 10% in the same bond would still be able to qualify for a zero rate of AIL.

32. Some submissions sought clarification of what would be covered by the stock exchange test and the exclusions for “private placements” and bonds that were not “openly advertised”. In response to these submissions, the following changes were made:

- The stock exchange test was clarified so that it would require debt securities to be listed on an exchange that is “registered under the Securities Market Act 1988” (currently, the NZDX is the only registered debt exchange). Note that this would not accommodate offshore exchanges such as the ASX. Such exchanges do not contribute to the New Zealand bond market.
- The requirement that the bonds be “openly advertised” was replaced with a requirement that the bonds be an “offer of securities to the public” under the Securities Act 1978. The Securities Act 1978 does not expressly define “an offer of securities to the public” but section 3 of the Act provides guidance as to how the phrase should be interpreted.

33. The private placement exclusion could be clarified by defining a private placement as "an offer of securities addressed solely to a restricted set of persons known to the issuer or underwriter." An alternative would be to leave this term undefined and rely on its ordinary commercial meaning.

34. The Treasury and the Reserve Bank were consulted throughout the policy development process, including on the design of the qualifying criteria. They agree with the final proposal.

## CONCLUSIONS AND RECOMMENDATIONS

35. We recommend implementing a zero rate of AIL for bonds that qualify under the criteria set out above (principally, the stock exchange and widely held tests), with AIL still applying at a 2 percent rate on closely held debt (such as bank loans).

36. This would make qualifying bonds a relatively cheaper source of finance, although there is uncertainty about the extent to which this would lead to an increase in bond market activity. This is because many factors influence the cost of different funding sources and corporate funding decisions and the fact that the proposed criteria would generally exclude "wholesale" bonds (bonds issued to a small number of institutional investors). As noted, wholesale bonds make up over half of the existing corporate bonds.

37. A zero rate of AIL on bonds is estimated to cost about \$5 million per annum based on bond market data for the previous 3 years. There could be a significant risk to the corporate tax base if the zero rate of AIL applied to closely-held debt. The design of the qualifying criteria attempts to manage this risk.

## IMPLEMENTATION

38. A zero rate of AIL on qualifying bonds could be implemented in the next available tax bill which is scheduled for introduction in October 2010, although there would be no serious implications if this measure was delayed. Administration of the new rate of AIL would be carried out by Inland Revenue in accordance with existing practices for administering the approved issuer levy and non-resident withholding tax.

39. Because the rate of AIL is self-assessed, there is a risk that some issuers may incorrectly apply the qualifying criteria. This risk is reduced by the use of "bright-line" tests and by basing the criteria on existing regulations or commercial terms. Explanations and examples of how these tests and terms should be applied will be published in a Tax Information Bulletin.

**MONITORING, EVALUATION AND REVIEW**

40. Practical and remedial issues will be identified by bond market participants, tax practitioners and front-line Inland Revenue staff and then communicated to the relevant policy person. Any necessary corrections or improvements could be included in a subsequent tax bill. Suggestions for substantial policy change could be considered for inclusion on the Tax Policy Work Programme.