Regulatory Impact Statement

The withholding tax treatment of inflation-indexed bonds.

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

The question addressed in this Statement is whether the withholding tax rules that apply to inflation-indexed bonds in the Income Tax Act 2007 should minimise, where appropriate, potential inefficiency that these tax rules may cause the inflation-indexed bonds market. This Statement also questions whether the tax rules should be aligned more closely with the current commercial practice in relation to the timing of the deduction of the withholding tax on the inflation-indexed component.

The key policy objectives are to ensure that there is an appropriate tax treatment for inflation-indexed bonds that reflects as closely as possible the current commercial practice and to minimise the impact of the withholding tax rules on the efficiency of the inflation-indexed bond market.

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

Targeted consultation has been undertaken with current and past issuers of inflation indexed bonds and the Rewrite Advisory Panel (an independent panel established by the Minister of Revenue in 1995). This consultation helped define the problem, and develop the options and analysis summarised in this statement.

The Treasury has been consulted and agrees with our analysis.

The preferred options have no fiscal implications and are to maintain the revenue base.

There is a very small likelihood that the proposed changes may increase the compliance costs for bond issuers in relation to their record keeping obligations and the return filing obligations of bond holders if the inflation rate were to increase significantly. The proposed change 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. As part of the 2012 Half Yearly Economic Fiscal Update, the Crown announced that it intended to target up to 10-20% of total bonds outstanding over time in an inflation-indexed bonds format. The Government had previously issued inflation indexed bonds in 1996 but suspended issuance in 1999.

2. Inflation-indexed bonds are intended to diversify the Crown's investor base, to provide long-term cost-effective funding for the Government and to provide investors with a hedge against inflation as recommended by the Capital Market Development Taskforce in 2009, and in accordance with the 2010 Government Action Plan.

3. Two tax technical issues have been identified with the reissuance of these bonds:

Issue one: withholding tax exceeding the coupon payment

4. The withholding tax rules in the Income Tax Act 2007 (the Act) oblige any person who makes a payment of resident passive income or non-resident passive income (or a payment that includes such income) to deduct tax from the payment unless an exemption applies. In the case of an inflation-indexed bond, the bond issuer is obliged to withhold resident withholding tax (RWT) or non-resident withholding tax (NRWT) from the bond holder's coupon (interest) payment and the inflation-indexed component.

5. In general terms, RWT is withholding tax deducted and paid by New Zealand issuers on interest and dividends paid to New Zealand resident taxpayers. Generally the income is returned in the taxpayer's annual tax return and credit is given for tax withheld.

6. NRWT is a withholding tax deducted and paid by New Zealand based payers of interest, dividends or royalties to non-residents. Generally it is a final income tax on such payments for New Zealand tax purposes.

7. The primary problem is the potential for a withholding tax obligation to exceed coupon amount. In this situation, the issuer of an inflation-indexed bond would have a liability to pay withholding tax, but no administratively workable "payment" to deduct it from.

8. Generally if an incorrect amount of withholding tax has been deducted, the withholding tax rules allows a payer of RWT or NRWT to make up the difference by deducting the tax from subsequent payments made during the same tax year. If there is insufficient cash-flow to cover the underpayment, potentially the bond issuer could reduce the capital value of the bond.

9. However this would result in the bonds being non-fungible, as the bonds would reduce in value by different amounts based on the varying withholding rates across bond holders. Over time, multiple categories of otherwise identical bonds would be created and would reduce the trading market for such bonds. In turn, this reduces the attractiveness to holders of the bond and potential investors, as a liquid market is one of the benefits of such bonds.

10. The root cause of the problem is that the current withholding tax rules are inclined towards ensuring that the withholding tax obligations are met rather than minimising, where appropriate, potential inefficiency that these tax rules may create for the inflation-indexed bonds market by reducing the fungibility of bonds.

11. At present this problem is a potential risk rather than an actual problem. The current coupon rate for the new issue of inflation-indexed bonds is 2% per annum, and this low coupon rate increases this potential risk. For example the following table provides an indication of what the rate of inflation needs to be in order for the potential risk to eventuate into a problem.

Tax type and rate	Coupon rate	Inflation rate for the coupon payment to be insufficient
RWT at 33%	2%	4.1%
RWT at 30%	2%	4.7%
RWT at 17.5%	2%	9.5%
NRWT at 15%	2%	11.3%

12. While the risk of withholding tax exceeding the coupon payment is currently perceived to be low, if the inflation rate were to increase significantly there may be cash flow issues for bond issuers, and potentially tax collection consequences if bond issuers are unable to absorb the underpayment of withholding tax, if the inflation rate were to increase significantly.

13. The other factor mitigating the potential risk of the withholding tax exceeding the coupon payment is if the non-resident is subject to approved issuer levy (AIL) rather than NRWT. Approved issuers are able to pay interest to non-residents without deducting NRWT. Instead approved issuers are required to pay a levy at the rate of 2% for every dollar of interest paid on the bond. The new issue of indexed-inflation bonds will provide that a non-resident investor will be subject to approved issue levy unless an election is made for NRWT to apply therefore the group of non-residents who are actually applicable for NRWT is likely to be very small.

Issue two: timing of the withholding tax deduction

14. The second and related problem stems from a timing issue. The Act intends that withholding tax should be deducted annually from the inflation-indexed component. However, the coupon is generally paid quarterly and the administrative practice of bond issuers is to withhold the tax on the inflation-indexed component for the previous quarter, and deduct it from the coupon payment.

15. There is no explicit permission in the Act to withhold the tax obligation quarterly, and this can result in an unclear situation where an issuer may be withholding tax from a coupon amount in advance of the bond holder's legal obligation, because there is some form of cash-flow from which to deduct the withholding tax. The root cause of this problem is a misalignment between the Act and commercial practice.

16. Because of the misalignment and the cash-flow considerations to meet the withholding tax obligations, issuers of bonds have (to date) inserted a clause in their agreement with bond holders to authorise withholding the tax on the inflation-index component amounts from the coupon payment when they are paid (credited to the account of the holder).

OBJECTIVES

17. A fundamental consideration of a coherent, broad-base, low-rate tax system is that taxes should be efficient through minimising distortions and impediments to economic growth, while still maintaining the tax revenue and encouraging voluntary compliance (the integrity of

the tax system). The key policy objectives are to ensure that there is an appropriate tax treatment for inflation-indexed bonds that reflects as closely as possible the current commercial practice and to minimise the impact of the withholding tax rules on the efficiency of the inflation-indexed bond market.

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

REGULATORY IMPACT ANALYSIS

19. To achieve the objectives outlined above, a number of options to address issues one and two were considered.

Issue one: withholding tax exceeding the coupon payment

20. There are three options that may deal with issue one and achieve the objective of minimising the impact of the withholding tax rules on the inflation indexed bonds market:

- 1A limiting the bond issuer's obligation to resident withholding tax to the amount of the coupon, with corresponding record keeping amendments so that bond issuers notify bond holders of their requirement to file and the Commissioner of Inland Revenue of any remaining tax liability (preferred option).
- 1B limiting the bond issuer's obligation to resident and non-resident withholding tax to the amount of the coupon, with corresponding record keeping amendments so that bond issuers notify bond holders of their requirement to file and the Commissioner of Inland Revenue of any remaining tax liability.
- 1C making the bond issuer liable for the resident and non-resident withholding tax underpayment.

21. The status quo is unsatisfactory because it has the potential to create an inefficient inflation-indexed bonds market because bonds may become non-fungible due to the withholding tax rules, and it does not reflect current commercial practice.

Option 1A (preferred option)

22. This option limits the bond issuer's obligation to resident withholding tax to the amount of the coupon, but does not limit NRWT to the amount of the coupon. Therefore where a coupon payment is less than the amount of tax for both or either payments, the liability for payment of any RWT underpayment is met by the bond holder through a "wash-up" payment initiated by filing an income tax return. This ensures that the correct amount of income tax is paid on the income earned from the inflation-indexed bonds.

23. In order for Inland Revenue to administer this proposed solution, additional record keeping and information amendments to the Tax Administration Act 1994 will be needed, so that bond issuers notify bond holders of their requirement to file and the Commissioner of Inland Revenue of any remaining tax liability.

24. This option achieves the policy objective of minimising the impact of the tax treatment of inflation-indexed bonds on the bonds market, as the bond holder will not have to deduct the remaining tax liability from the face value of the bond therefore creating non-fungible and different classes of bonds. The integrity of the tax system is also maintained by not extending

the coupon limitation to NRWT, as it will ensure that non-residents satisfy their New Zealand tax obligations.

25. The table on page 3 also shows that the annual rate of inflation would need to be 11.3% in relation to NRWT, therefore showing that the potential risk is more heightened for RWT than NRWT.

26. Furthermore as noted in the status quo, AIL will apply in most circumstances, therefore mitigating the risk of issue one occurring to a certain extent.

27. This amendment will maintain the revenue base, and is not expected to have any fiscal impact.

Option 1B

28. Similar to option 1A, this option limits the bond issuer's obligation to RWT to the amount of the coupon. However this option is more extensive in that it would also apply to NRWT. There would also need to be corresponding amendments to the record keeping provisions in the Tax Administration Act 1994 so that Inland Revenue can administer these changes as per option 1A. This option is further mitigated by AIL as noted in option 1A.

29. Like option 1A, this option will achieve the policy objective of minimising the impact of the tax treatment of inflation-indexed bonds on the bonds market, as the bond holder will not have to deduct the remaining tax liability from the face value of the bond therefore creating non-fungible and different classes of bonds. This option will have some administrative impacts as bond holders who are not residents of New Zealand (and are therefore subject to NRWT), will have to file a tax return, whereas generally they do not as NRWT is a final tax for New Zealand tax purposes.

30. This option may also have a fiscal risk if there is non-compliance, as Inland Revenue will have to monitor and collect any underpayments of NRWT. It is difficult to quantify what the fiscal risk may be, but it is likely to be low, due to the number of non-residents bond holders who are more likely to be subject to AIL than NRWT.

Option 1C

31. This option involves the bond issuer of the inflation-indexed bond carrying the shortfall of the tax liability.

32. This amendment will maintain the revenue base, but will have a fiscal cost to the bond issuers, including the Government. It is difficult to quantify what exactly the fiscal cost may be, as it will vary according to the volume of the bonds that are issued, the coupon rate and the rate of inflation.

Issue two: timing of the withholding tax deduction

33. There are two options that may deal with issue two and achieve the objective of reflecting as closely as possible the current commercial practice:

- 2A withhold the tax from each coupon payment when it is paid.
- 2B retain the status quo.

Option 2A (preferred option)

34. This option allows the withholding tax deduction to be withheld from the coupon payment when it is paid to the bond issuer. This option aligns the Income Tax Act 2007 with the current commercial practice that is either currently exercised by bond holders or agreed to by bond holders and bond issuers under the bond memoranda (contract).

35. The amendment provides timing options for bond holders and therefore encourages voluntary compliance by giving more choice as to when the deduction occurs.

Option 2B

36. This option retains the status quo, whereby the timing of the tax deduction is a matter (whether contractual or not) between the bond issuer and the bond holder.

TABLE A ***Issue one:*** ***withholding tax exceeding the coupon payment***

Option	*Meets Objective?*	*Impacts*				*Net Impact*
			Fiscal/economic impact	*Administrative/ compliance costs*	*Risks*	
1A Limiting the bond issuer's obligation to resident withholding tax to the amount of the coupon, but not NRWT, with corresponding amendments to the record keeping provisions. (preferred option)	Yes	Tax system	No fiscal impact, as maintaining the revenue base.	None, changes will be implanted using current administrative systems.	None	Improves status quo by ensuring tax rules do not create inefficiencies in the inflation-indexed bonds market and maintains the integrity of the tax system by ensuring that non-residents comply with their New Zealand tax obligations.
		Bond issuers	No economic impact as bonds remain fungible.	In the event the problem does eventuate due to the inflation profile changing significantly, there may be some transitional compliance costs due to additional record keeping and notification provisions.		
		Bond holders	No economic impact as bonds remain fungible.	If the inflation profile changes significantly, there is likely to be additional compliance costs due to additional filing requirements.		
1B Limiting the bond issuer's obligation to	Yes	Tax system	May be fiscal impact if there is non-compliance but likelihood is low.	Will create administrative costs, as Inland Revenue will be required to monitor non-resident compliance and administer any enforcement. Likely to be	The filing requirements for non-residents may create disincentives to invest in inflation-indexed bonds due to the additional filing	Improves status quo slightly by ensuring tax rules do not create inefficiencies in the inflation-indexed bonds market, however the additional compliance costs for non-residents who are now required to

Option	Meets Objective?	Impacts				Net Impact
			Fiscal/economic impact	*Administrative/ compliance costs*	*Risks*	
resident and non-resident withholding tax to the amount of the coupon with corresponding amendments to the record keeping provisions.				administratively intensive with minimal result, as only a small group of taxpayers have deductions under NRWT, as the majority of non-residents who invest in bonds are taxed using the approved issuer's levy not NRWT .	requirements for non-residents.	file may dis-incentivise any investment in inflation-indexed bonds and may increase non-compliance by this group.
		Bond issuers	No economic impact as bonds remain fungible.	May be some transitional compliance costs due to additional record keeping provisions.		
		Bond holders	No economic impact as bonds remain fungible.	Likely to be compliance costs due to additional filing requirements for residents. Likely to be greater compliance costs for non-residents, as generally NRWT is a final withholding tax and the non-resident will now be required to file.		
1C Bond issuer of the inflation	No	Tax system	Likely to be a fiscal impact as the Government is an issuer of inflation indexed bonds, and will be liable for any tax	No administrative costs.	Non-government bond issuers may not have fiscal ability to absorb any underpayments of	Maintains the status quo, as although bonds maintain their fungibility, there is a disincentive for any non-Government bond issuers to issue such bonds as they

Option	Meets Objective?	Impacts				Net Impact
			Fiscal/economic impact	*Administrative/ compliance costs*	*Risks*	
indexed bond to carry the shortfall of the RWT and NRWT tax liability			liability shortfall. Difficult to quantify the fiscal cost as it will depend on the volume of bonds issued, the rate of the coupon and the rate of inflation.		withholding tax.	may not have the fiscal ability to absorb any underpayments of withholding tax, therefore creating inefficiencies, as there are less bond issuers in the market. The bond issuers may also incur costs of finding alternative borrowing.
		Bond issuers	Non-Government bond issuers may not have the fiscal ability to absorb any underpayment of withholding tax and therefore will create economic disincentive to offer inflation indexed bonds.	No additional compliance costs.		
		Bond holders	No economic impact as bonds remain fungible.	No additional compliance costs.		

TABLE B *Issue two: timing of the withholding tax deduction*

Option	*Meets Objective?*	*Impacts*				*Net Impact*
			Fiscal/economic impact	*Administrative/ compliance costs*	*Risks*	
2A Withhold the tax from each coupon payment when it is paid.	Yes	Tax system	No fiscal impact.	Encourages compliance as better alignment between commercial practice and the Income Tax Act 2007.	None	Improvement in the status quo as this option aligns the Income Tax Act 2007 with the current commercial practice, and does not impact on the current policy settings as the tax is still being withheld. The difference is when it is withheld, and this option gives more timing options for bond issuers, therefore encouraging compliance.
		Bond issuers	No economic impact.	No change but greater certainty as law is aligned with current commercial practice.		
		Bond holders	No economic impact.	No change but greater certainty as law is aligned with current commercial practice.		
2B Retain the status quo.	Yes	Tax system	No change.	No change.	None	The status quo remains whereby there is an element of uncertainty where bond issuers are deducting tax before the legal requirement to do so.
		Bond issuers	No change.	If no clause in Bond Memoranda, the tax is being deducted earlier than the Income Tax Act 2007 requires. This may be problematic for the bond issuer if this is challenged by the bond holder, and may incur administrative costs if the bond issuer needs to change timing of the tax deduction from quarterly to annually as per the law.	None	
		Bond holders	No change.	No change.	The bond holder can challenge	

Option	*Meets Objective?*	*Impacts*				*Net Impact*
			Fiscal/economic impact	*Administrative/ compliance costs*	*Risks*	
					the bond issuer's timing of the tax deduction if it is not contracted for in the Bond memoranda, or not annually as required by the Income Tax Act 2007.	

Social, environment or cultural impacts of all options

37. There are no social, environmental or cultural impacts to any of the options. The groups affected by the amendments are bond issuers and bond holders who invest or issue inflation indexed bonds.

CONSULTATION

38. Targeted consultation has been undertaken on the problems and possible solutions with interested parties and a tax advisory panel.

39. Discussions were held with the only current bond issuer - the Government (managed through Treasury's New Zealand Debt Management Office) and a previous issuer of inflation-indexed bonds. The Treasury's tax strategy team and Treasury's New Zealand Debt Management Office brought these issues to Inland Revenue's officials' attention and worked with Inland Revenue through the possible options including what administrative issues may arise from a bond issuer's and tax administration perspective.

40. Treasury officials discussed the problems and proposed options with a previous bond issuer. This company was relaxed about the proposals as they noted the risk was relatively minor, and given their current coupon rate of 4%, inflation would need to be at 12% for these problems to eventuate. This company noted that the additional record-keeping and information requirements were possible through their current systems therefore the operational impact from these changes on their organisation was likely to be minimal.

41. The Rewrite Advisory Panel (RAP) was also consulted as part of these proposals and recognised that the issue in relation to RWT is a matter of priority and suggested the same legislative amendments. However RAP also noted that similar issues arise in relation to NRWT and suggested that the obligation to withhold NRWT should also be limited to the amount of the coupon.

42. Officials disagreed with RAP for the reasons summarised in Table A. That is, the rationale for recommending a limit for RWT only is that workable mechanisms can be adopted to collect any shortfall in RWT as part of the annual return filing process. With respect to NRWT, while the same mechanisms can be provided to collect any shortfall, collection of any NRWT shortfall (either through a payment or tax return filing mechanism) is often administratively intensive with minimal result. NRWT for the majority of non-resident holders is also a final withholding tax. Not extending the coupon limitation to NRWT is to maintain the integrity of the tax system and ensure that non-residents satisfy their New Zealand obligations. Furthermore non-residents can be subject to AIL.

CONCLUSIONS AND RECOMMENDATIONS

43. The recommended options to address the problems are:

Issue one: withholding tax exceeding the coupon payment

Option 1A (amend the Income tax Act 2007 to limit the obligation to withhold resident withholding tax up to the amount of coupon with corresponding record keeping amendments so that bond issuers notify bond holders of their requirement to file and the Commissioner of Inland Revenue of any remaining tax liability), as this option achieves the policy objective with less impact on compliance, administrative and fiscal costs than the other two options for this issue.

Issue two: timing of the withholding tax deduction

Option 2A (amend the Income Tax Act 2007 to allow the issuer of an inflation-indexed bond to withhold resident and non-resident withholding tax from both the coupon and the inflation-indexation payment, when the coupon is paid), as this option achieves the policy objective and encourages compliance by providing more choices for the timing deduction for bond issuers.

44. Overall for both issue one and issue two, the proposed amendments will ensure that where practicable the tax law is aligned with the commercial practice adopted by inflation-indexed bond issuers, in aligning the withholding tax deduction on the inflation-indexed component to when the coupon is paid and tax withheld from that amount. Also the proposed amendments ensure that by limiting the RWT withholding obligation to the amount of the coupon payment, that tax will not be a possible impediment to and efficient inflation-indexed bond market.

45. However, officials do not consider that this limitation proposal should be afforded to NRWT because of the tax compliance risk that non-residents may not meet any tax underpayment obligations.

IMPLEMENTATION

46. The necessary legislative changes would be included in the Taxation (Annual Rates, Employee Allowances, and Remedial Matters) Bill which is scheduled to be introduced in late October 2013, with application from date of enactment. There is no need for transitional provisions.

47. There should be no significant implementation issues with the amendments. Inland Revenue will communicate the changes to taxpayers and their agents through existing channels, such as the *Tax Information Bulletin* and through updating its guides.

48. The additional information regarding any RWT underpayment may increase compliance costs for bond issuers. However it is likely that the increase will be negligible as it can be easily incorporated into existing record-keeping requirements already imposed on the bond issuers.

49. The proposed amendments do not provide any opportunity to reduce or remove any existing regulations.

50. No additional enforcement strategy is required to achieve the policy outcomes being sought.

MONITORING, EVALUATION AND REVIEW

51. There are no specific plans to monitor, evaluate and review the changes under the Income Tax Act 2007 following the changes, given that this issue is to help prevent any risk to the tax base.

52. Officials would expect that if any concerns are identified with the application of the proposed options, the Treasury's New Zealand Debt Management Office and the Treasury would raise it with Inland Revenue officials.

53. In general, Inland Revenue monitoring, evaluation and review of new legislation takes place under the Generic Tax Policy Process (GTPP). The GTPP is a multi-stage tax policy process that has been used to design tax policy in New Zealand since 1995. The final stage in the GTPP is the implementation and review stage, which involves post-implementation review of the legislation, and the identification of any remedial issues. Opportunities for external consultation are also built into this stage. In practice, any changes identified as necessary for the new legislation to have its intended effect would generally be added to the Tax Policy Work Programme, and proposals would go through the GTPP.