Regulatory Impact Statement

PIE Credit Impairment Provisions

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by the Treasury and Inland Revenue.

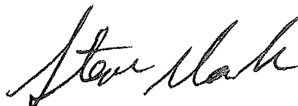
It provides an analysis of options to clarify the current uncertainty around the ability of portfolio investment entities (PIEs) to claim a tax deduction for credit impairment provisions. It answers the question of whether PIEs should be able to claim a tax deduction for their credit impairment or doubtful debt provisions.

As this issue impacts on the daily unit pricing of managed funds and it is understood that the majority of managed funds have been using the PIE timing rules as the authority to claim tax deductions for credit impairment provisions, there is a pressing need to provide operational certainty for the industry.

As a result, this issue has not been subject to the full generic tax policy process. However, analysis on this issue has applied the framework of principles outlined in the *Government Statement on Regulation* and the *Tax Review 2001*. The key focus of tax policy is to enhance the overall economic well-being of New Zealanders by seeking ways to reduce the costs of imposing taxes while promoting fairness and continuing to raise sufficient revenue.

As part of this analysis, we have consulted with the Investment Savings and Insurance Association, Trustee Corporations Association of New Zealand Inc, New Zealand Institute of Chartered Accountants, New Zealand Law Society, PricewaterhouseCoopers, Deloitte, KPMG and Ernst & Young. This consultation highlighted the compliance costs of disallowing a deduction for PIE credit impairment provisions and led to the recommendation of option two (deduction for credit impairment provisions), which was a change from the initial policy position.

The analysis undertaken has considered whether options for resolving the current uncertainty around the treatment of credit impairment provisions would impose additional costs on business. In particular, one of the policy options (i.e. option one that denies deductions for credit impairments) is seen as giving rise to transitional issues (both from a compliance and administration cost perspective). This is because the majority of PIEs have effectively taken their deductions as if they were dealers in financial arrangements. As such, restricting tax deductions would be seen as an unfavourable retrospective change to the legislation. Doing so would require most PIEs to amend tax positions already taken and also create significant compliance costs with respect to unit pricing and investor equity issues where investors have changed over time.



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12 March 2010

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Context

The portfolio investor entity (PIE) rules have their own timing rule for income and tax deductions which allocates PIE income and deductions to the period when these amounts are reflected in the PIE's unit price, usually on a daily basis. The purpose of this rule is to maintain investor equity over time by ensuring that investors exiting the fund are attributed their correct share of the fund's tax. This prevents the fund from being required to make complex (and often inaccurate) provisions for future tax liabilities and deductions in the fund's unit price.

The Income Tax Act 2007 currently contains differing timing provisions for income tax deductions.

PIEs have been using a special timing provision within that regime (section EG 3) as authority to claim deductions for credit impairment provisions at the time these are reflected in the unit price. However, this approach differs from the general tax treatment of credit impairment provisions for individual investors and is technically incorrect. It was never intended that section EG 3 would authorise deductions. Rather it was intended that section EG 3 would set the timing for claiming deductions authorised elsewhere in the legislation.

An amount is only deductible for tax purposes if permitted under Part D of the Income Tax Act 2007. Under Part D, an amount is generally only deductible for tax purposes if it has been incurred. This is unlikely to be the case for credit impairment provisions. The exception is for dealers in financial instruments who are allowed a deduction under the financial arrangement rules. However, even where a PIE meets the definition of a dealer, there is a lack of clarity as to whether the PIE timing rule or financial arrangement rules take precedence.

Disallowing deductions for these provisions (which would occur if no government action is taken) would give rise to significant transitional issues (both from a compliance and administration cost perspective). This is because, from consultation, we understand that the majority of PIEs have followed the scheme of the PIE rules and the treatment under the financial arrangement rules for dealers and claimed a deduction for their credit impairment provisions.

However, disallowing deductions for credit impairment provisions would be consistent with the treatment of individual investors (a core objective of the PIE rules) and other lenders (such as banks and finance companies). Adopting a consistent treatment between PIE lenders and other lenders avoids creating pressure from other lenders to allow them tax deductions for credit impairment (and other accounting) provisions.

Question and objectives

The question addressed is whether PIEs should be able to obtain a tax deduction for their credit impairment or doubtful debt provisions.

Since 1995, tax policy in New Zealand has been developed in accordance with the Generic Tax Policy Process.

Analysis of this issue has applied the framework of tax policy principles outlined in the *Tax Review 2001.* These are that the key focus of tax policy is to enhance the overall economic well-being of New Zealanders by seeking ways to reduce the costs of imposing taxes – or making the tax system more efficient – while promoting fairness and continuing to raise sufficient revenue.

Tax design should be guided by generally accepted principles of fairness, namely that people in the same position should be treated similarly, that people should contribute in accordance with their ability to pay, and that tax reform should be transparent and prospective.

Taxes will generally impose economic costs, because they induce individuals to make decisions that they would not have made in the absence of the tax. At its broadest, excess burden includes the costs of misallocating scarce economic resources, tax administration by government and tax compliance by taxpayers.

Regulatory impact analysis

Two options for resolving the uncertainty around tax deductions for PIE credit impairment provisions were identified:

- Amend the PIE timing rules to prevent tax deductions for credit impairment provisions and bad debts to the extent that individual capital account investors would not qualify for deductions.
- Amend the PIE timing rules to allow a deduction for credit impairment provisions where the underlying loss would eventually be tax deductible.

The option of allowing a deduction for bad debts was discounted because PIEs are unable to deal with timing differences as a result of their daily unit pricing obligations and multiple investor tax rates. This was confirmed during consultation.

Option one: Disallowing a deduction for credit impairment provisions and bad debts

Option one involves amending the PIE rules to prevent a tax deduction for credit impairment provisions and bad debts.

Economic and compliance impacts

Option one ensures a more consistent treatment with individual investors (a core objective of the PIE rules), as summarised in the following table.

	Lender on capital account (individual investor)	Lender on revenue account (business lender)	Dealer in financial arrangements
Credit impairment provision	No deduction	No deduction	Deduction under financial arrangement rules
Bad debts	Generally, no deduction for capital	Deduction for both interest and capital When debt written off	Deduction for both interest and capital if credit impairment deduction has not already been claimed

Fiscal impacts

An amendment to prevent PIEs from claiming a tax deduction for credit impairments and bad debts is potentially tightening the existing rules. We have been unable to quantify the exact fiscal impact of this option. However, this is unlikely to involve significant revenue as from consultation we understand that the majority of PIEs have already claimed tax deductions for their credit impairment provisions.

Aligning the PIE treatment with that already available to individual investors also avoids pressure from other lenders (such as banks and finance companies) to allow them tax deductions for credit impairment (and other accounting) provisions. Extending tax deductions for credit impairment or other accounting provisions generally would have a significant fiscal cost. For example, allowing a tax deduction for credit impairment provisions held by banks would have an estimated one-off fiscal cost of $250 million[1].

This option also avoids the risk of taxpayers manipulating the level of deductions. By disallowing a deduction for both doubtful and bad debts, option one also avoids creating a deferred tax problem for PIEs.

Social, cultural and environmental impacts

No impacts identified.

Option two: Allowing a deduction for credit impairment provisions

Option two involves amending the PIE rules to allow a deduction for credit impairment provisions at the point that these are reflected in the unit price.

Economic and compliance impacts

This treatment is consistent with the scheme of the PIE rules. The PIE timing provision is intended to avoid timing differences and ensure investor equity over time. Because of their flow through treatment, the changing mix of investors and multiple tax rates, timing differences create significant compliance and investor equity issues for PIEs. This is because PIEs are unable to estimate which taxpayers (at which tax rates) will be investors at the time that tax timing adjustments reverse.

Amending the PIE rules to allow a deduction for credit impairment provisions at the point that these are reflected in the unit price would be consistent with New Zealand's comprehensive income tax which aims to tax the economic definition of income (excluding capital gains) as closely as possible. Credit impairment provisions are an estimate of the economic loss that investors will suffer. These provisions flow into the unit price and can result in an actual fiscal loss where investors leave the fund.

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[1] This was the estimated fiscal cost in 2007 and is now likely to be significantly higher due to the impact of the global financial crisis.

For example, a fund has one investor who invests $100. The unit price is $100. Due to deteriorating economic conditions, the fund expects a 50% loss. A $50 credit impairment provision is created, which reduces the unit price to $50. If the investor leaves the fund, they will have suffered a $50 economic loss. As such, there is an argument to support a tax deduction for the impairment provision.

Option two is also consistent with the approach for dealers under the financial arrangement rules. Dealers in financial instruments are able to adopt a market value option whereby financial arrangement income or expenditure is calculated as the change in the market value in the course of an income year. This effectively allows a deduction for credit impairments which impact on the market price. This treatment is consistent with the fact that taxpayers who adopt this option pay tax on an accruals basis where their financial arrangements increase in value over an income year.

In order to adopt the market valuation method, the Commissioner must have approved the market and the source of information used to determine market values or the taxpayer must demonstrate that market prices are available.

While amending the PIE rules to allow a deduction for credit impairment provisions at the point that these are reflected in the unit price, does offer advantages in terms of consistency of treatment with scheme of the PIE regime, economic definition of income and treatment under the financial arrangement rules, it does have some disadvantages.

This option would be inconsistent with the treatment of individual investors, and would open up a tax deduction for credit impairment provisions to a wider group of taxpayers, creating a differential treatment between PIE lenders and other lenders, for example trading banks. While there are arguments to support a differential treatment (for example, the compliance costs associated with daily unit pricing and multiple tax rates), it may be difficult to maintain a boundary between PIEs and other lenders.

Due to its wider application, option two also has a greater risk of taxpayers manipulating the level of deductions. This risk is increased under the PIE rules due to the fact that tax losses and excess tax credits are cashed-out to investors. Investors receive an actual cash rebate which increases the incentives to claim greater deductions by inflating the level of the credit impairment provision.

There are some natural restrictions on the manipulation of PIE credit impairment provisions:

- The majority of PIEs consider that they meet the definition of a dealer under the financial arrangement rules. As such, the valuation of these provisions would be subject to the same controls that exist for an approved market under the financial arrangement rules.

  The exception is mortgage investment funds. These PIEs do not trade their financial arrangements. As such, they would currently not be eligible for a credit impairment deduction under the financial arrangement rules. Amending the PIE rules to allow a deduction for credit impairment provisions would therefore be an extension of the current treatment for these funds. There is also unlikely to be an

approved market value for these investments, which increases the fiscal risk regarding valuation of provisions.

- Credit impairment provisions impact on the unit price which is detrimental to retaining and attracting investors. The protection offered by the unit price may be less effective where a fund has deteriorated to the point where it has been closed to new investors. However, even where a fund is closed, trustees still have fiduciary duties to ensure a correct unit price.

- Credit impairment provisions form part of audited IFRS accounts.

- The PIE rules also contain the 20% single investor ownership restriction which should prevent a single investor from controlling PIE decisions on provisioning.

Fiscal impacts

As the majority of managed funds have been using the PIE timing rule as the authority to claim tax deductions for credit impairment provisions, a technical change to ensure sufficient authority for the underlying tax deductions should be revenue neutral as these costs are already within baselines.

Fiscal concerns around those PIEs that have not already claimed a tax deduction for their credit impairment provisions could be addressed through transitional rules. There is precedent for retrospective tax changes which confirm the tax position already taken by taxpayers, but would not allow other PIEs to retrospectively claim tax deductions for these provisions. This treatment is also consistent with the fact that PIEs, due to their daily unit pricing and multiple investor tax rates, would have difficultly retrospectively claiming a tax deduction. It is also a timing issue, as these PIEs will be able to claim a tax deduction at the point that the law is changed.

Social, cultural and environmental impacts

No impacts identified.

Consultation

As this issue impacts on the daily unit pricing of managed funds and it is understood that the majority of managed funds have been using the PIE timing rules as the authority to claim tax deductions for credit impairment provisions, there is a pressing need to provide operational certainty for the industry.

As a result, this issue has not been subject to the full generic tax policy process. However, analysis on this issue has applied the framework of principles outlined in the *Government Statement of Regulation* and *Tax Review 2001*. The key focus of tax policy is to enhance the overall economic well-being of New Zealanders by seeking ways to reduce the costs of imposing taxes while promoting fairness and continuing to raise sufficient revenue. As part of this analysis, officials consulted with the Investment Savings and Insurance Association, Trustee Corporations Association of New Zealand Inc, New Zealand Institute of Chartered

Accountants, New Zealand Law Society, PricewaterhouseCoopers, Deloitte, KPMG and Ernst & Young. Consultation took the form of meetings.

The majority of the industry supported option two. It did not support amending the tax treatment to align with individual investors as this framework is not applied consistently. While PIEs have been granted a capital account treatment for their Australasian equity investments, financial arrangement investments are taxed on an accrual basis.

This treatment was also seen as giving rise to significant transitional issues (both from a compliance and administration cost perspective) as the majority of PIEs have followed the scheme of the PIE rules and the treatment under the financial arrangement rules for dealers. As such, restricting tax deductions would be seen as a taxpayer unfavourable retrospective change to the legislation. It would require most PIEs to amend tax positions already taken and also create significant compliance costs with respect to unit pricing and investor equity issues where investors have changed over time.

The industry therefore supports amending the PIE rules to provide a tax deduction under option two. The industry considers that concerns around fiscal cost and valuation of provisions are addressed by the fiduciary duties placed on trustees, protection provided by the unit price and normal commercial practices followed to calculate the level of any credit impairment.

This consultation highlighted the compliance costs of disallowing a deduction for PIE credit impairment provisions and led to the recommendation of option two, which was a change from the initial policy position.

Conclusions and recommendations

Option one involves amending the PIE rules to prevent a tax deduction for credit impairment provisions and bad debts. This would ensure a more consistent treatment with individual investors (a core objective of the PIE rules) and avoid pressure from other lenders (such as banks and finance companies) to also allow them tax deductions for credit impairment (and other accounting) provisions. Option one also avoids the risk of taxpayers manipulating the level of deductions.

Option two involves amending the PIE rules to allow a deduction for credit impairment provisions at the point that these are reflected in the unit price. This treatment is consistent with the scheme of the PIE rules and New Zealand's comprehensive income tax which aims to tax the economic definition of income (excluding capital gains) as closely as possible. It is also consistent with the approach for dealers under the financial arrangement rules who can adopt a market value option, which effectively allows a deduction for credit impairments which impact on the market price.

Option two would provide a tax deduction for credit impairment provisions to a wider group of taxpayers, creating a differential treatment between PIE lenders and other lenders, for example trading banks. It also carries a greater risk of taxpayers manipulating the level of deductions.

In general, the industry does not support amending the tax treatment of credit impairment provisions to align with individual investors as this framework is not applied consistently. Disallowing deductions for these provisions is seen as giving rise to significant transitional issues (both from a compliance and administration cost perspective) as the majority of PIEs have followed the scheme of the PIE rules and the treatment under the financial arrangement rules for dealers.

The industry considers that concerns around fiscal cost and valuation of provisions under option two are addressed by the fiduciary duties placed on trustees, protection provided by the unit price and normal commercial practices followed to calculate the level of any credit impairment.

On the basis of this consultation and the reasoning set out above, officials recommend a change to allow PIEs a tax deduction for credit impairment provisions where they apply a market valuation basis under the financial arrangement rules (i.e. option 2).

Implementation

Implementing the amendments will require changes to the Income Tax Act 2007. These amendments could be included in the taxation bill intended to be introduced in July 2010.

It is recommended that the change is retrospective to the start of the PIE regime. However, to ensure the clarification is fair to PIEs and investors, transitional rules should confirm tax positions already taken without allowing PIEs to retrospectively claim tax deductions for these provisions. There is precedent for retrospective tax changes which confirm the tax position already taken by taxpayers. This treatment is also consistent with the fact that PIEs, due to their daily unit pricing and multiple investor tax rates, would have difficultly retrospectively claiming a tax deduction. It is also a timing issue, as these PIEs will be able to claim a tax deduction at the point that the debts are written off.

The proposed option would minimise compliance costs for taxpayers by confirming the tax positions already taken. Officials would also publish further information on the changes in the Inland Revenue's Taxation Information Bulletin to assist taxpayer's in confirming their tax positions.

Officials would consult with the managed funds industry in developing the necessary changes to the legislation to ensure that the changes result in certainty of treatment for credit impairment provisions.

Any amendment to the Income Tax Act 2007 would also be subject to the normal select committee process. As a result, the managed funds industry would have an opportunity to submit on the proposed clarification to ensure that this achieves the necessary certainty of treatment for credit impairment provisions.

The Policy Advice Division of Inland Revenue liaises closely with Inland Revenue's Large Enterprises assurance team responsible for auditing PIE returns. As part of this ongoing relationship, confirmation would be sought that the proposed change results in certainty of treatment for credit impairment provisions.

Monitoring, evaluation and review

As discussed above, monitoring, evaluation and review includes consultation with the industry on the draft legislation, the normal select committee process and liaison with Inland Revenue's Large Enterprises assurance team.