Impact Summary: Securitization of pre-1990 forestry emissions units

Section 1: General information

Purpose
The Inland Revenue Department is solely responsible for the analysis and advice set out in this Regulatory Impact Statement, except as otherwise explicitly indicated. This analysis and advice has been produced for the purpose of informing policy decisions to be taken by Cabinet.
Key Limitations or Constraints on Analysis
Quality of data used for impact analysis Inland Revenue used public information available on holders of pre-1990 emission units to inform our analysis of the proposed approach discussed in this Impact Summary. This information, however, did not provide any insights about taxpayers' use of the emission units, including decision-making behaviours over holding or trading these units. Targeted consultation with interested stakeholders was carried out to bridge this gap in our knowledge; however, for the reasons set out below, there were time constraints on the period of consultation. **Consultation and testing** A private sector stakeholder who raised the initial concerns about the tax treatment of arrangements to securitise emission units was influential in shaping the problem definition. While the ideal response to the concern was to include the issue in a wider context as part of an examination of the use of the financial arrangement rules, the scheduling of this review meant it could not address this issue in a sufficiently timely manner. Analysis of the problem definition and possible options for change led officials to conclude that there was a case for developing an interim solution, focusing on pre-1990 forestry emissions units only, which would address the stakeholder's concern. The recommended interim solution is consistent with current tax policy settings and the framework underpinning the interim solution is sustainable and robust. A consequence of developing the interim solution in a sufficiently timely manner was that it truncated the timeframe that would otherwise be available for consultation to just over one week. Engagement with relevant stakeholders in the public and private sector was high, with most responding either via telephone or letter. Subject to decisions by Cabinet, further consultation on the detailed design of the proposal will be carried out before final decisions, as delegated by Cabinet, are made by Ministers. The wider review of the financial arrangement rules is on the Government's tax policy work programme and will consider if the scope of the interim solution should be extended.

Responsible Manager (signature and date):
Peter Frawley Policy Manager Policy and Strategy Inland Revenue Department May 2018

Section 2: Problem definition and objectives

2.1 What is the policy problem or opportunity?

This Regulatory Impact Analysis addresses the question of whether current taxation laws, particularly the Income Tax Act 2007 (the Income Tax Act), impedes financial decision-making by holders of pre-1990 forestry emissions units that are held for intergenerational purposes.

Pre-1990 forestry emissions units

New Zealand's emissions trading scheme (ETS) distinguishes between pre-1990 forest land and post-1989 forest land, 1990 being the base year of measurement under the Paris agreement, The scheme places mandatory deforestation obligations on exotic forests that were first established before 1990, referred to as 'pre-1990 forests'. This means if pre-1990 landowners choose to deforest, for example when converting forest land to a different use, they face 'deforestation liabilities' under the ETS, have to report on emissions and surrender an equivalent amount of New Zealand emission units to the Government. When the ETS was introduced, owners of 'pre-1990 forests', were able to apply for a one-off free allocation of New Zealand emissions units. This allocation was intended to recognise the possible impact on land values due to the cost New Zealand's ETS places on deforesting, and the resulting reduction in land-use flexibility.

A wide variety of owners applied for the free units, including farmers with small forest holdings, regional councils, owners of large commercial forests, and Māori entities who received forest land as part of treaty settlements. In total, nearly 48 million pre-1990 units were issued, 38 million of which are still held today, some of which have been either sold or surrendered.

The tax treatment also distinguishes between pre-1990 forestry emissions units and post-1989 forestry emissions units. As a transitional measure, the first disposal of emissions units by taxpayers who received the initial allocation of pre-1990 emission units is not treated as income under the Income Tax Act. Subsequent transactions are subject to normal tax treatment on disposal. The special tax treatment for pre-1990 emission units reflects the transitional nature of those units under the ETS, as outlined above.
Public information on the use of pre-1990 forestry emissions units suggests that a large proportion are held long-term. As the units themselves do not produce income, the cash value of these assets can only be realised on disposal. For holders that want to take a long-term inter-generational approach, the units can represent an unproductive asset. The Inland Revenue Department (Inland Revenue) was approached by a private sector stakeholder about changing the Income Tax Act so that unit holders could extract value from the emission units using sale and compulsory buy-back arrangements without triggering a sale for tax purposes.

Sale and compulsory buy-back arrangements

It is a well-established principle of interpretation that the tax treatment of a transaction follows its legal form. When a taxpayer sells property, such as pre-1990 forestry emission units, with a compulsory obligation to buy the same or equivalent property back, the tax rules treat the transaction as a disposal – that is, the taxpayer alienates all rights in the property.

By treating the sale and compulsory buy-back arrangement as a disposal for tax purposes, taxpayers extinguish the benefit of the tax transitional treatment for pre-1990 forestry emissions units. Economically, however, the transaction is a loan or lease of property. As the

tax treatment follows the legal form of the transaction rather than its economic substance, tax law can act as an impediment to unit holders seeking to extract value from emissions units that are held for inter-generational purposes.

Agreements involving the sale and compulsory buy back of property are typically referred to as "securitization". Securitization usually involves using a long-term asset as security in return for a payment for up to the asset's worth that is repayable at a specified later date. The borrower can use the asset for the period but the expectation is that the asset or an asset of an equivalent nature will be returned to the lender when the monies are paid back. As the set of transactions is in-substance a loan or lease, the tax consequences should follow the difference in the net cash flows as a measure of income, expenditure or loss arising from the arrangement. A netting approach is more consistent with existing tax policy frameworks when economic ownership of the asset is not surrendered.

Case for change

The approach to Inland Revenue for legislative reform was motivated by a unit holder wanting to enter into a significant transaction that would allow them to lend the emissions units to a third party who will likely use the units to offset liabilities connected with their emissions. Because the agreement requires the unit holder to reacquire the units at a specified future date, the property rights in the units cannot be said to have been extinguished or disposed of. In return for the emissions units, the unit holders would receive monies that could be used to produce income, such as interest. Tax law, however, inhibits such arrangements as they would result in the pre-1990 forestry emissions units losing their one-off tax-free status, and limits options for unit holders to seek opportunities to maximise the value from otherwise unproductive assets on their balance sheet.

Work on the issue was initially planned for late 2018. However, an impetus for dealing with this issue more quickly is the fact that the stakeholder who approached Inland Revenue is planning to enter into a sale and buyback transaction of pre-1990 forestry emissions units by the end of May 2018. In the absence of the proposed change, the transaction is unlikely to take place.

There is high confidence in the evidence and assumptions underpinning the case for change.

2.2 Who is affected and how?

The key group of taxpayers affected by the change are holders of pre-1990 forestry emissions units. Preliminary indications from this group, via targeted consultation with a selected group of unit holders with an interest in inter-generational asset retention and growth, were supportive of any reform that would allow them to maximise value from these units without losing any tax transitional benefits.

2.3 Are there any constraints on the scope for decision making?

Tax issues with securitization of assets are not isolated to pre-1990 forestry emissions units. Other assets that could be securitised can be similarly affected, but reforming tax law generally for all assets at this stage has a risk of unintended consequences. Inland Revenue does not have sufficient evidence at this time to advance regulatory reform, even at an in- principle level, for the treatment of long term assets that are not pre-1990 forestry emissions units. Developing a response for pre-1990 forestry emission units only at this time is a reflection of the constraints on our analysis.

The wider issues concerning the securitization of assets are scheduled to be considered as part of the review of the financial arrangement rules as announced as part of the Government's tax policy work programme.

Section 3: Options identification

3.1 What options have been considered?

The **main** objective is to ensure that the tax system recognises the economic substance of arrangements that securitise pre-1990 forestry emissions units and ensures that tax law does not inhibit opportunities to maximise the value of those units. The following criteria have been used to assess the options:

- Effectiveness: the options should not act as a disincentive for holders of pre-1990 forestry emissions units to maximise value from those units.
- Sustainability: the options should maintain the integrity of the income tax, and operate coherently with the frameworks used by the Income Tax Act.
- Fairness: the options should apply equally to all taxpayers. Like-transactions should have similar or equivalent tax outcomes.
- Administration efficiency and compliance efficiency: the option should not introduce new processes or procedures that would not otherwise arise under the Income Tax Act.

As the obligations, rights and entitlements of taxpayers are prescribed by legislation, non-legislative responses, apart from the status quo (which does not meet the main objective), are not viable.

Effectiveness was the most important criterion at it aligned closest with the main objective. There was little difference between the options in terms of impact on compliance and administration efficiencies.

Option one: Status quo

Under the status quo, the sale and compulsory buy-back arrangement is treated as a disposal for tax purposes and taxpayers lose the benefit of the tax transitional treatment for pre-1990 forestry emissions units. Current tax policy settings inhibit unit holders from maximising the value of pre-1990 forestry emissions units unless they are sold. As such, the option is not effective and does not meet the main objective.

The status quo is consistent with interpretation principles insofar as the Income Tax Act applies to transactions involving the transfer of property. As such, the status quo is arguably fair. Officials are aware, however, that broader concerns have been expressed that the current position is not sustainable and for this reason the tax treatment of sale and compulsory buy-back arrangements is part of a proposed review of the financial arrangement rules on the Government's tax policy work programme.

Option two: Apply the principles of the financial arrangement rules to securitised pre-1990 forestry emissions unit transactions

Under option two the securitization of pre-1990 forestry emissions units would be treated as a financial arrangement under the Income Tax Act. The financial arrangement rules tax all returns on financial arrangements on an accrual basis over the term of the arrangement, including the returns on instruments that can alter the incidence of those returns. Tax outcomes under the financial arrangement rules would align with the economic substance of

the securitization arrangement. This outcome means that option two is effective for the purpose of meeting unit holder expectations regarding their tax obligations and preserves the special tax transitional treatment of pre-1990 forestry emission units until such time as the unit holder choses to alienate their rights to the units.

Option two uses existing tax frameworks in the Income Tax Act and is sustainable because it maintains the integrity of the tax base by ensuring that interest cash flows created by the arrangement are appropriately taxed.

Option two does not rely on the creation of new frameworks and does not create any new or additional compliance or administration costs and meets the administration and compliance cost efficiency criterion.

This option could result in market changes regarding the supply and demand of pre-1990 forestry emissions. Commoditizing such emissions units improves market liquidity but also introduces market risk (such as price and counter party default). We expect that holders of pre-1990 forestry emissions units would carry out appropriate due diligence before entering into any sale and compulsory buy-back arrangements to mitigate these risks.

The option does not fully meet the fairness criterion as it applies to pre-1990 forestry emissions units only. The fairness criterion would be fully met if the proposed approach applied to emissions units generally. Widening the scope of option two is not preferred at this time although officials will be considering in the coming months whether it would be desirable to also include post-1989 forestry emissions units in the proposed amendment prior to the legislation being introduced late this year. Originally, Inland Revenue had intended to discuss the securitization of emissions units in an officials' issues paper for later in 2018. However, the impetus for dealing with pre-1990 forestry emissions units more quickly is the fact that a key stakeholder is planning to enter into a sale and buy-back transaction at the end of May 2018 and has sought an assurance from Ministers that there is support for legislative change to the Income Tax Act to ensure that tax law reflects the economic substance of the transaction.

Preliminary feedback from stakeholders has been supportive of option two.

Other options: Apply the principles of the share lending rules to pre-1990 forestry emissions units

Other options were briefly considered. For example, the share lending rules which are based on a similar securitization concept. Share lending involves the lending of shares to another party for a fee. The share lending rules in the Income Tax Act tax transactions on the basis of economic substance rather than legal form. The share lending rules met some of the evaluation criteria (effectiveness, and administration and compliance efficiency) but did not adequately reflect the underlying cash flows under this particular type of securitization arrangement as the share lending rules are specifically targeted to shares. Therefore, it was dismissed as an option as it was not sustainable, notwithstanding its effectiveness.

3.2 Which of these options is the proposed approach?

The proposed approach is option two, which relies on the principles and framework of the financial arrangement rules in the Income Tax Act to appropriately tax securitization arrangements involving pre-1990 forestry emissions units. This option is preferred as it meets the main objective and is effective and sustainable. By using existing frameworks in the Income Tax Act, it does not create new compliance or administrative processes.

The proposed approach has no areas of incompatibility with the Government's expectations for the design of regulatory systems.

Section 4: Impact Analysis (Proposed approach)

4.1 Summary table of costs and benefits

Affected parties *(identify)*	**Comment**: nature of cost or benefit (e.g. on-going, one-off), evidence and assumption (e.g. compliance rates), risks	**Impact** *$m present value, for monetised impacts; high, medium or low for non-monetised impacts*
Additional costs of proposed approach, compared to taking no action		
Regulated parties	On-going compliance costs of the proposed approach are comparable to the status quo.	Low
Regulators	Administration costs of the proposed approach are comparable to the status quo.	Low
Wider government	Revenue effect is negligible for several reasons: in the absence of legislative change it is unlikely securitization transactions involving pre-1990 emissions units would go ahead.	Low
Other parties	None	Low
Total Monetised Cost		Low
Non-monetised costs		Low
Expected benefits of proposed approach, compared to taking no action		
Regulated parties	Tax environment supports securitization of pre-1990 emissions units allowing holders to maximise the value of those assets.	Low
Regulators	None	Low
Wider government	None	Low
Other parties	Users of emissions units to offset emissions may find suppliers of pre-1990 units more willing to lease or loan those units due to the neutral tax environment created by the proposed approach.	Low
Total Monetised Benefit		Low
Non-monetised benefits		Low

4.2 What other impacts is this approach likely to have?

Inland Revenue officials are aware that a review of the emissions trading scheme is currently underway. The proposed approach is not anticipated to have any impacts on the outcome of this review.

To provide certainty for stakeholders, the proposed approach would apply from the start of the 2018-19 income year for transactions entered into from that year. Applying the change from this time gives assurance and certainty to the stakeholder (and others) who initially raised concerns that the Income Tax Act was limiting opportunities for holders of pre-1990 forestry emissions units to maximise the value of those assets.

Section 5: Stakeholder views

5.1 What do stakeholders think about the problem and the proposed solution?

The problem with the current tax rules as they apply to securitization of pre-1990 forestry emissions units was brought to Inland Revenue's attention by a specific taxpayer. Taxpayer secrecy prevents Inland Revenue from naming this taxpayer. The taxpayer has been consulted throughout the policy development process.

Inland Revenue also undertook targeted in-confidence consultation, via letter, with a selection of the larger holders of pre-1990 forestry emissions units to test initial reactions to the proposed approach. The letter sought stakeholder views about the proposed change. Feedback supported a change from the status quo. Inland Revenue also carried out follow up contact via telephone with stakeholders. Their feedback was very positive.

One submitter suggested the amendment should extend to the securitization of any forestry emissions units, not just pre-1990 forestry emissions units. The submitter's point is that owners of post-1989 forestry emissions units tend to retain them to cover the future surrender obligations that arise under the emissions trading scheme when the forests are harvested. Being able to securitize those units in the meantime would be useful for the owners of post-1989 forestry emissions units.

Over the coming months Inland Revenue will consider and report back to Ministers on whether the proposed amendment should be extended to all emissions units, or alternatively, whether any extension should be left to be considered as part of the financial arrangements issues paper. This consideration should not, however, hold up obtaining Cabinet agreement to a legislative tax amendment for pre-1990 forest land emissions units. More generally, Inland Revenue considers any wider securitisation issues should be considered as part of the proposed review of the taxation of financial arrangements, which is planned for later in 2018. The outcome of this review is not expected to result in changes that would be inconsistent with the proposed approach discussed in this Impact Summary.

Separate from the review of the taxation of financial arrangements, an additional round of consultation is proposed about the detailed design of the proposed approach before final policy decisions are made by Ministers. Cabinet is being asked to delegate authority to the Minister of Revenue to finalise the detailed design of the proposed approach.

Another round of consultation will also be available as part of Parliament's consideration of any legislative amendment through the Parliamentary select committee process.

The Treasury was consulted as part of the policy development process and supports the measure being taken to Cabinet for approval. The Ministry for Primary Industries, the Ministry for the Environment and the Office of Treaty Settlements were also consulted and did not identify any concerns with the proposed approach.

Section 6: Implementation and operation

6.1 How will the new arrangements be given effect?

Legislative change to the Income Tax Act 2007 is necessary to implement option two. These amendments would be included in an omnibus taxation bill planned for later in 2018. The changes would apply to securitization transactions entered into by taxpayers from the 2018-19 and later income years.

Stakeholder feedback has not highlighted any concerns regarding compliance with the proposed approach and it has been positively received.

When the bill is introduced into Parliament, a Commentary on the bill will be concurrently released explaining the amendments. Further explanation about their effect will be contained in Inland Revenue's *Tax Information Bulletin* series, which would be released shortly after the bill receives Royal assent.

Inland Revenue would administer the proposed legislative changes. Enforcement of the changes would be managed by Inland Revenue as business as usual. Inland Revenue has assessed the magnitude of the administrative impacts and considers that the proposed approach can be implemented and made effective for transactions entered into anytime from the start of the 2018-19 income year.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?
Inland Revenue would monitor the outcomes as per the objectives of the Generic Tax Policy Process (GTPP) to confirm that the proposed approach meets its objectives. The GTPP is a multi-stage policy process that has been used to design tax policy in New Zealand since 1995. Monitoring of the proposed approach will be done through existing relationships Inland Revenue has with relevant stakeholders and their advisors.
7.2 When and how will the new arrangements be reviewed?
A proposed review of the financial arrangement rules is on the Government's tax policy work programme for later 2018. It will consider a variety of financial arrangement taxation issues ranging from remedial to policy enhancements to ensure the rules work as intended. This review will ultimately involve the preparation of a public consultation document and the opportunity for stakeholders to comment. Any concerns identified by stakeholders about the proposed approach discussed in this Impact Summary, including its possible extension to other assets, would be considered as part of this review.