Regulatory Impact Statement

Listed PIEs – Grouping of Tax Losses

Agency Disclosure Statement

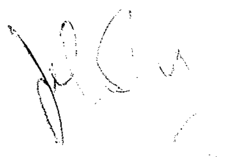
This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of a potential investment structure, under the current tax law, involving a listed PIE (a type of portfolio investment entity that is a listed company). The structure raises policy concerns because it would undermine the company tax/imputation system by enabling investors to obtain an unintended tax benefit from company tax losses. This possibility arises because income that has not been taxed at the listed PIE level can be distributed to investors tax-free under the PIE rules, and because existing law allows ordinary companies to group with listed PIEs for the purpose of utilising tax losses.

Other than set out in this Disclosure Statement and the broader Regulatory Impact Statement, no significant gaps, assumptions, dependencies, constraints, caveats or uncertainties have been identified.

In preparing this statement, we have consulted with the Treasury, which agrees with our analysis.

The proposed change does not impose additional costs, impair private property rights, reduce market competition, provide disincentives to innovate and invest or override common law principles. The change would help to protect the tax base against inappropriate tax structures involving listed PIEs. It should have little or no impact on existing taxpayers, given that we are not aware of any evidence that the potentially problematic investment structure we have identified is currently in use.



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STATUS QUO AND PROBLEM DEFINITION

1. A listed PIE (a type of portfolio investment entity that is a listed company) is currently allowed to use the tax losses of another company in the same group to offset its taxable income. Two companies are regarded as part of the same group for these purposes if a person (or persons) holds common ownership in the companies of at least 66%. This is in contrast with the treatment of so-called "multi-rate PIEs", which are only allowed to group tax losses with land-owning subsidiaries or other multi-rate PIEs.

2. The concern with the current rules is that a company with losses may establish a listed PIE in order to make tax-exempt distributions to investors in a way that undermines the company tax and imputation systems and PIE principles. This concern arises because, unlike ordinary company dividends, distributions by PIEs are tax-free to investors regardless of whether they are imputed. A listed PIE may invest by debt into a related company that, in itself, would not qualify for PIE status. Allowing the non-PIE loss to offset PIE income may allow the non-PIE income to be distributed by exempt dividend to investors.

3. If a person invested directly in the company with losses, they would generally receive unimputed dividends on which tax would be payable. However, if shares are instead issued by a listed PIE, which then on-lends funds to the company with losses, the investor could receive a tax-free return. Interest earned by the PIE on the transaction would be taxable, but could be covered by a transfer of the parent company's losses under the current grouping rules.

4. This potential structure raises policy concerns, as it would undermine the company tax/imputation system. In particular, the listed PIE rules allow an unintended tax benefit to arise from ordinary company tax losses. This arises because income that has not been taxed at the listed PIE level can be distributed to investors tax-free. Therefore, a more advantageous tax outcome can be achieved from investing via a listed PIE, compared with investing directly. In addition, the loss-making company is provided with an avenue for using its losses.

5. Retaining the status quo would mean that the potential investment structure outlined above would remain available under the legislation.

6. This RIS considers how the law can be amended to address this potential issue.

OBJECTIVES

7. The main objective is to prevent the use of the type of structure outlined above to obtain more favourable tax treatment than would be available without the use of a listed PIE. A further objective is to ensure similar treatment of listed PIEs and multi-rate PIEs under the loss-grouping rules.

REGULATORY IMPACT ANALYSIS

8. The options that we have identified are to retain the status quo or to amend the loss-grouping rules to prevent a company with losses from establishing a listed PIE subsidiary in order to make tax-exempt distributions to investors. Other options were not explored, as the latter option of amending the grouping rules had already been used previously with respect to multi-rate PIEs.

9. Retaining the status quo would not achieve the objectives described above. It would leave open the risk of listed PIEs being used in an unintended manner to provide tax benefits to investors, and it would not achieve consistency in the treatment of listed PIEs and multi-rate PIEs under the loss-grouping rules.

10. Retaining the status quo would have no social, environmental or cultural costs, but may have a fiscal cost over time if companies with losses seek to exploit the rules in the way described. This cost is difficult to quantify as we are not aware of any such structures being used at the moment.

11. The preferred option is to amend the loss-grouping rules as they apply to listed PIEs, as it would address the problem outlined above. It is proposed to take a similar approach to that already used in respect of multi-rate PIEs. This would mean introducing a rule providing that a listed PIE could only group with its own wholly-owned subsidiaries. This option would ensure that a loss-making New Zealand company could not use a listed PIE to provide investors with the tax benefits of its losses.

12. The preferred option has no fiscal, social, environmental or cultural costs. Given that we have not identified any structures of the type outlined above being used at the moment, it is unlikely that the preferred option will increase compliance costs on businesses or individuals.

CONSULTATION

13. Inland Revenue has consulted on the proposal via letters to a range of interested parties, including the Investment Savings and Insurance Association, the Corporate Taxpayers Group, the New Zealand Institute of Chartered Accountants, the New Zealand Law Society and the major accounting firms.

14. Submitters did not consider that the proposed amendment raised any concerns.

15. Inland Revenue has also consulted with the Treasury.

CONCLUSIONS AND RECOMMENDATIONS

16. The recommended option is to amend the tax legislation to include a provision in the grouping rules, restricting a listed PIE to only grouping losses with its own wholly-owned subsidiaries. The amendment will ensure similar treatment of listed PIEs with multi-rate PIEs.

IMPLEMENTATION

17. The necessary legislative change will be made in the November 2010 tax bill, with application from the date of Royal assent.

18. As a similar rule already applies with respect to multi-rate PIEs, implementation risks are low.

MONITORING, EVALUATION AND REVIEW

19. On an ongoing basis, Inland Revenue will monitor the outcomes pursuant to the Generic Tax Policy Process to confirm that they match the policy objective.