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This paper contains advice that has been prepared by the Tax Working Group Secretariat for consideration by the Tax Working Group.

The advice represents the preliminary views of the Secretariat and does not necessarily represent the views of the Group or the Government.

Appendix D: Changes to loss continuity rules

Further information on potential revenue-reducing options

July 2018

Prepared by the Inland Revenue Department and the New Zealand Treasury

Proposal

1. The proposal is to direct Inland Revenue to work on relaxing the loss continuity provisions.

2. Loss restrictions can create disincentives to take risk, and can act as an artificial barrier to bringing in new capital for small companies with losses. The proposal to direct Inland Revenue to work on a discussion document with a view to loosening the rules would ideally lead to a tax system where risk is treated more neutrally and barriers to bringing in new capital for small and growing firms is reduced.

Introduction

3. Losses and income are treated asymmetrically under New Zealand's company tax system[1]. When income is positive, taxes are paid by the company to the government. However, when losses occur, the government does not provide a refund[2]. Instead, any unused losses can be carried forward to offset income of the company that might be earned in future years.

4. Loss continuity rules apply to determine whether losses from a previous year can be applied in a year. Generally, losses may be applied if there has not been a breach of continuity since the losses were incurred. A breach of continuity occurs when there is a significant change of ownership of the company. For this purpose a significant change is more than 51% of the voting interest of the company.

5. New Zealand's loss continuity rules are more stringent than many other OECD countries, including Australia. This has led to calls for a relaxation of the rules.

6. Policy decisions with respect to the loss continuity rules require a balance between concerns about efficiency of business arrangements and preserving government revenues and maintaining the integrity of the tax system.

7. As such, rules in this area can directly impact physical/financial capital by affecting business investment decisions. They can also impact social capital, more indirectly, through perceptions of fairness of the tax system and by affecting government revenue and the capacity to fund government priorities.

Loss continuity rules in other countries

8. Most countries that allow losses to be carried over after a breach in continuity follow some variation of a "continuity of business" test. That is, the business that generated the losses must continue to be carried on after the breach of continuity. In many cases, the losses are restricted to offset the future income from the business. How exactly this is implemented varies significantly between countries.

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[1] As they are in all other tax systems.

[2] There are targeted exceptions. For example, New Zealand, like a number of other countries, provides payments when taxes are otherwise zero with respect to some R&D expenditures.

9. A general reason for these restrictions is to prevent the trading of losses. Under a pure loss trading transaction, an otherwise dormant company that has accumulated losses can be sold to a taxpaying company, so that the purchasing company's income can be sheltered by the losses. The policy reflects an objective that there is an underlying business reason for the purchase of the loss company. The purchase should not be motivated solely to use the losses to offset tax on other income.

10. In some countries this is linked to rules that are intended to ensure that the value of loss deductions is not increased by the breach of continuity.

Key policy issues

11. The main policy issues can be divided between those affecting efficiency and those affecting revenues and the integrity of the tax system.

Efficiency issues

12. Efficiency can be impaired by loss continuity rules if they impose disincentives to undertake certain types of investments or through effects that discourage otherwise efficient types of business arrangements.

Discouraging efficient business arrangements

13. There are a number of natural business arrangements involving possible continuity breaches that could be discouraged if the predecessor company has loss carry-forwards. Typical situation include:
    - sale of a company by a controlling shareholder, such as a founder/entrepreneur cashing out of a start-up;
    - acquisition of a company, with the intention of using the predecessor company's business assets in a continuing business;
    - merger of two companies with synergies;
    - IPO of a start-up; and
    - major capital raising to fund business expansion.

14. In some cases, there are strategies to avoid the loss of continuity, but these can be complicated.

15. In other cases, otherwise desirable arrangements may be delayed or foregone. At the least, they are penalised.

16. In 2004 New Zealand took the view that these issues could be sufficiently problematic for firms undertaking R&D that rules were introduced that effectively allowed losses created by R&D-related costs to be carried forward by deferring their recognition at the option of the taxpayer. Such deferred costs are preserved when there is a breach of continuity. However after a breach the deductions are capped by the income arising from the R&D work of the company.

Asymmetric treatment of losses and risk

17. The asymmetric treatment of losses in general discourages risk-taking. Loss carry-forwards mitigate that effect. However, when loss continuity rules extinguish losses, this mitigation is eliminated. This has the effect of increasing the riskiness of investments where the business maybe sold in the future.

18. The effect of asymmetric treatment on risk is a significant issue with company taxation in general. However, the effect of the loss continuity rules on risk are likely to be secondary compared to negative effects they can have for efficient business arrangements.

19. The amount of losses extinguished on breach of continuity is not directly reported. However, analysis of loss data over the periods 2012 to 2016 suggests that some $200 million of losses may be extinguished each year. This compares to a total loss carry-forward pool of some $44 billion. Thus loss continuity rules are a very small part of the asymmetry story.

Revenue and integrity concerns

20. The chief concerns that have led to restrictions on loss carry-forwards on a breach of continuity have been with regard to revenue and integrity risks.

Revenue risks

21. The estimated cost related to relaxing the loss continuity rules is between $30 million and $60 million if reform is made along the lines of a "same or similar" business test. However there is a pool of tax loss carry-forwards of $44 billion with a tax value of over $12 billion. If only a small percentage of this pool could use the new rules to accelerate the use of tax losses, the costs to the government could be much higher than the estimate.

22. The potential risk to the revenue base is closely linked to the integrity issues discussed in the next section.

Integrity concerns

23. Loss trading can occur through a number of mechanisms. One method is to sell a company that has little or no assets other than accumulated tax losses. This occurred in a number of countries in the 1980s, including New Zealand. Newspaper ads were taken out advertising loss companies for sale, quoting a price for losses.

24. There are two situations where this can occur described below.

25. An otherwise dormant company with losses can be sold to a profitable company. In recent years, dormant companies have held between $1.5 and $2 billion of losses.

26. However, a certain proportion of the total $44 billion of losses would also be at risk. A firm that did not expect to be able to use its losses for a number of years could move the assets from the loss company into a related company, and then sell the loss company to a profitable company.

27. Under a pure income tax, losses would be immediately refunded by the government, and so from a pure policy point of view the trading of losses might seem attractive. However the governments of the day could not accept the large revenue losses; nor the appearance of the banks and large companies who bought the losses not paying tax. Moreover, such do-it-yourself refundability does not have the audit protection needed for large scale refund programmes. Accordingly a number of provisions were introduced to prevent loss trading.

28. In 2016, New Zealand introduced a limited refundability programme for R&D.

Potential relaxation of continuity rules

29. There are reasonable policy arguments to provide some relief for losses carried forward on a breach of continuity. They basically respond to concerns that the rules could discourage otherwise efficient sales or refinancing of companies that are part of the ordinary evolution of businesses. However, this is an area where there are significant integrity and revenue risks. Thus rules would need to be structured to protect against loss-trading and unforeseen revenue losses.

30. A number of approaches are possible, and discussed below.

Continued use of the assets of the loss company

31. One option is to require the continued use of the assets of the loss company after the breach of continuity. The test is often applied for a number of years, say three or five. This seems a rather restricted and old-fashioned conception. It may make sense to rationalise operations. More importantly, intellectual property makes up an increasing proportion of the value of businesses. The business may be effectively continued without the use of pre-existing facilities.

Limited to income from the loss business

32. This is essentially the approach taken under the New Zealand R&D loss carry-forward rules. It requires an annual accounting of income arising from the former loss business. In a more general rule, where there are similar operations undertaken by an acquiring company, especially as operations are integrated, such separate accounting may be complex and potentially contentious.

Same or similar business test

33. In part to avoid the problems of identifying the income of the former loss business, countries have broadened the test to "same or similar" businesses.

34. The experience in Canada has been that the Courts have interpreted "similar" quite broadly. For example:
    - a similar business would include the same type of business in another location, not using the assets of the loss company;
    - a gas distribution company was found to be similar to a loss company that converted vehicles to natural gas;
    - selling clothes was found to be similar regardless of whether the operation was retail or wholesale, or the clothes were for men or women; and
    - the use of recreational land was similar regardless of the type of activity.

35. If "similar" is interpreted broadly, it becomes a strange criterion if the underlying rationale is continuity of business. It is not clear why "similar" businesses should be able to effectively engage in loss trading while other businesses cannot.

36. At the very least, there is unlikely to be any link to the amount of income that would have been earned, and therefore losses used, by the prior loss business.

37. In operation, this test it is rather open ended and arbitrary.

Australian review

38. In 2011 the Australian Business Tax Working Group (BTWG) was established, and one of the issues looked at was the tax treatment of losses. The Group's final report on the issue is extensive, with one chapter devoted to loss carry-forwards and the same business test[3].

39. The BTWG identified similar policy objectives identified to those discussed earlier in this report. The BTWG characterised them as "preventing tax driven trading in companies and ensuring the continued use of losses if a change of ownership occurred for commercial reasons", but also stated that "the tax treatment of losses should reflect the broader policy that the tax system should not impede businesses from innovating or from adapting to changes in economic circumstances". We agree with those objectives.

40. The BTWG thought that the same business test was too narrow and restrictive. It looked at three models:
    - Replacing it with a dominant purpose test, which would allow all losses to be carried forward unless the losses were obtained through a transaction undertaken for the dominant purpose of obtaining a tax loss.
    - Modifying the same business test to allow the types of changes that are commonly made to businesses to restore or enhance profitability.
    - A "drip-feed" mechanism that limited the amount of losses that could be used in any year.

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[3] Chapter 4 of the report.

41. Ultimately, the BTWG recommended that the Australian Government undertake further analysis with a view to developing a model for reforming the same business test. The model suggested by the BTWG was one that combined modification of the same business test so that it better aligns with the modern business environment, and introducing an alternative statutory drip-feed mechanism.

42. One point to note from the BTWG work is that Australia, that already has a more relaxed rule for carrying forward of losses, is concerned that its rules are still too restrictive.

43. A second point to note is that this is a complex area. It is an issue that has a risk of serious downsides if relaxation allows a possibility that a material amount of the $44 billion of existing losses are used to offset income of currently profitable companies. In that regard, we suggest that the Group note this is an issue raised by submitters, note the importance of the issue for efficiency and productivity. If the Group thinks that this is important, we recommend they suggest that Inland Revenue work on this project with a view to issuing a discussion document in 2019 or 2020.

Cost

44. As noted above, the fiscal cost of moving to a same or similar business test is in the order of $30m to $60m per year.

Conclusions

45. Compared to a number of other OECD countries, New Zealand has reasonably stringent loss continuity rules. In most cases, New Zealand's rules eliminate loss carry-forwards when there has been a breach of continuity. This can inhibit otherwise productive sales or mergers of companies, and corporate refinancing. Relaxation of the rules could therefore lead to an increase in physical/financial capital.

46. Relaxing the rules is estimated to cost between $30 and $60 million annually.

47. On the other hand, existing banks of losses are very large, around $44 billion. Relaxing the rules carries with it the risk of significantly greater revenue losses, through trading of losses, where loss companies are sold so that their losses can be used to offset the income of profitable companies. Loss trading can also undermine the integrity of the tax system by allowing large companies and banks to avoid paying tax. This could erode social capital. While we are confident that we could eventually rule out that risk, it would take more careful detailed policy and drafting work that we could only do after a full consultation process.

48. We recommend that the Group:

- **note** the importance of the issue for efficiency and productivity, and,
- if the Group thinks that this is important, **agree** to include a recommendation in the interim report that the Inland Revenue Department work on this project with a view to issuing a discussion document in 2019 or 2020.