Tax Working Group Public Submissions Information Release

Release Document

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In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

22 November 2017

Hon Stuart Nash
Minister of Revenue
Parliament Buildings

Copy to:
Hon Grant Robertson, Minister of Finance
Hon Dr Megan Woods, Minister of Research, Science and Innovation

Dear Minister

THE INNOVATION ECONOMY – FURTHER POLICY REFORM

Congratulations on your appointment as Minister of Revenue.

We are writing regarding a proposal to amend the law that currently disadvantages many fast growing and innovative companies. Specifically, the proposal (as summarised in the Appendix to this letter) is to amend the current rule relating to the carry forward of tax losses by enacting a "same or similar business" test as an alternative to the existing 49% continuity of ownership requirement. Such a change would bring New Zealand's rules into line with those of many comparable jurisdictions, reduce compliance costs, and remove one of the tax impediments for innovative companies seeking to raise capital.

We met with former Ministers Collins and Goldsmith earlier this year in relation to the proposal. We also met with policy officials from Inland Revenue and Treasury, who have carried out some preliminary work in relation to the proposal. It was agreed with officials that the proposal would be included on the menu of potential reform proposals to be considered by Ministers for inclusion on the tax policy work programme when it is reset following the election.

Enclosed with this letter are the following papers (which were sent to the previous Ministers and officials from Inland Revenue and The Treasury):

(a) a Policy Paper outlining issues with the current law and a proposed same or similar business test for New Zealand; and

(b) a paper by Alex Duncan of Finology containing an economic impact analysis of the current test and how a same or similar business test could benefit New Zealand.

We propose to contact your office in the near future with a view to arranging a meeting with you to discuss this proposal.

Many thanks for your consideration of this matter.

Yours faithfully

[1]

Kirk Hope
Chief Executive, Business New Zealand

[1]

Suse Reynolds
Executive Director, Angel Association New Zealand Inc

[1]

Colin McKinnon
Executive Director, New Zealand Private Equity and Venture Capital Association

[1]

John Payne
Convenor, Corporate Taxpayers Group

APPENDIX

REDUCING A CURRENT TAX IMPEDIMENT TO INNOVATION, RISK-TAKING AND ATTRACTING NEW INVESTMENT: INTRODUCTION OF A BUSINESS CONTINUITY TEST IN THE TAX LOSS CARRY-FORWARD RULES

Executive summary for Stuart Nash (Minister of Revenue) 15 November 2017

Context

- Recent Government policy settings have acknowledged the importance of fostering business-led innovation and attracting high-quality investment to fund growth and innovation.

- The tax system should not include barriers to achieving those objectives by inhibiting business decisions regarding the raising of new capital investment or imposing additional cost on businesses seeking to innovate or take risks.

Problem definition

- Early stage, innovative companies are more likely than other companies to incur tax losses. At the same time, those companies are also likely to have changes of ownership as a result of raising new capital to fund research, development, innovation and growth.

- Tax losses have value to a company to the extent they are able to be carried forward and offset against future income. Forfeiture of tax losses erodes value for existing shareholders. The risk of forfeiture can therefore affect decision-making regarding the amount and timing of capital-raising and/or increase the required rate of return before investment is made in new ideas. It can also lead to migration of part or all of the business outside of New Zealand to a jurisdiction that better accommodates the innovation sector.

- New Zealand's current tax rules regarding the ability to carry forward tax losses depend solely on maintaining a minimum level of ownership continuity. If the statutory threshold (49%) is breached, tax losses are forfeited.

Distortions and inequities

- The current loss carry-forward rules create distortions and inequities, which would be addressed by a same business test. For example:

  – A mature company with other sources of income can immediately use deductions/losses from spending on innovation and new ideas (so the cost is only 72 cents in the dollar). For a company with no other (profitable) business, not only is no real time tax benefit available from the same spending, if losses are forfeited then such spending becomes "black hole" expenditure (so the cost is 100 cents in the dollar), even where the company subsequently becomes profitable.

  – Similarly, the current rules create a bias against high growth companies with an ongoing need for injections of new capital. Such companies are more likely to forfeit tax losses due to changes in ownership than low growth companies that can be funded by existing shareholders.

– If a limited partnership or look through company is used then the losses flow up to the investors and so are not at risk of forfeiture. However, the LTC regime is only available for closely held companies and limited partnerships are complex and unwieldy from both a governance/administrative perspective and a tax perspective when compared to a company.

Out of step with other countries, including Australia

- New Zealand's loss carry-forward rules are out of step with those of other countries, which generally have (as an alternative to continuity of ownership) a continuity of business test. That is, provided the company continues to carry on the same or a similar business, losses may be carried forward notwithstanding changes in ownership.
- In December 2015 the Australian Government announced that it would be changing its same business test (in place since 1965), by making it easier to satisfy, in order to further encourage entrepreneurship, innovation and diversification. This announcement followed from recommendations in 2012 by the Business Tax Working Group established by the Australian Treasury.
- Extracts from the Australian Treasury report are included in the Annex to this note.
- The proposed changes to the Australian law were included in the Treasury Laws Amendment (2017 Enterprise Incentives No. 1) Bill 2017.

Rule design and fiscal cost

- A robust same business test strikes a balance between allowing the carry forward of business losses where changes of ownership occur for genuine commercial reasons and preventing tax-driven "trading" in losses.
- A number of elements can potentially be incorporated into the rule to achieve those objectives, eg excluding losses of dormant companies, ring-fencing the use of losses to income from the same business (and not another business carried on by the company), and specific anti-avoidance rules. There is much international precedent to draw on in this regard.
- We will work with officials to help design a same business rule for New Zealand that is fit for purpose and maintains the integrity of the tax base. In addition, we can help officials profile the tax loss base to estimate the expected usage of carried forward tax losses should a same business test be implemented.
- The proposal would have a fiscal cost only to the extent that the companies in question become profitable and in fact use losses that would otherwise (ie under current law) have been forfeited to offset that profit. Such companies could be expected to be making a broader economic contribution, offsetting the "tax cost". There is no cost to the Government where the tax losses that are carried forward under the proposed new rule are not ultimately used (eg the business fails).
- Any loss in tax revenue from an increased use of tax losses should be more than offset by tax and other economic contributions from having more high-growth, innovative companies succeeding in New Zealand.

ANNEX

Extracts from the *Final Report on the Tax Treatment of Losses* (2012) (Australian Treasury Business Tax Working Group)

"The Working Group's terms of reference focus on reducing taxes on new investment to encourage Australian businesses to undertake innovation and entrepreneurial activity." (pg v)

"We have been asked to focus initially on how changes to the treatment of tax losses might help to relieve the tax burden on new investment." (pg v).

"… the current tax treatment of losses influences business decision making by creating a bias against riskier investments." (pg 16)

"The [continuity of ownership test] and [same business test] should operate together to balance two policy objectives: preventing tax driven trading in companies and ensuring the continued use of losses if a change in ownership occurred for commercial reasons." (pg 35)

"Creating a more effective [same business test] would be expected to result in benefits to commercial behaviour and positive risk taking. The Working Group considers that identification of appropriate amendments to the [same business test] should be a priority for the Government." (pg 35)

Legislation to amend the same business test and give effect to the Business Tax Working Group's recommendations was released for consultation by the Australian Government in 2016 and was introduced to the Australian Parliament in the Treasury Laws Amendment (2017 Enterprise Incentives No. 1) Bill 2017.