Tax Working Group Public Submissions Information Release

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Submission

By

New Zealand Private Equity and Venture Capital Association

To the

Tax Working Group

On the

Future of Tax

30 April 2018

Contact details:

The NZVCA would be happy to discuss the issues raised in this paper.

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INTRODUCTION

The New Zealand Private Equity and Venture Capital Association ("NZVCA") welcomes the Working Group's review of the NZ tax system. The NZVCA wishes to make submissions on several areas we believe are key to a successful and internationally competitive tax system.

However, it is first useful to provide the context and principle behind which this submission is made. At its simplest level, the NZVCA is here to support:

> ***the availability of capital, both monetary and human, to New Zealand's growing businesses, to encourage confidence and increase investment.***

BACKGROUND

Private capital is essential to the growth of New Zealand businesses both at the start-up phase and as businesses mature. The primary engines of growth in developed economies involve innovation and its successful commercialisation. Creating a positive regulatory and tax environment for private markets, especially in respect of early stage companies is critically important for the future of the New Zealand economy.

Growth capital is important for growing and financing NZ's physical capital and also for developing our human capital. Investment in NZ businesses and innovation provides opportunities for development of knowledge and skills for our people, particularly in emerging technologies and new industries.

Barriers to capital flows have a disproportionate effect on growth companies, which are often unable to raise capital by other means and rely heavily on domestic and foreign private capital investment. The availability and accessibility of investment capital is vital to the expansion of innovation and technology in the New Zealand economy.

As well as the importance of capital availability and accessibility, New Zealand's tax system should also take a considered and consistent approach across the entire investment life-cycle. Tax should not artificially increase the cost of capital throughout the term of an investment or distort investment or reinvestment decisions by acting as a barrier to innovation and technology.

When evaluating our tax system, we should have regard for many aspects that are currently fit for purpose. But the evaluation of our tax system cannot occur in a vacuum. Our tax system needs to be fit for purpose for New Zealand but also be competitive by international standards. The NZVCA is dedicated to improving private investment and increasing the openness to and availability of growth capital in the New Zealand market. We believe that tax should not distort or be a primary driver of investment choices, particularly in areas where new capital and expertise from investors are often the key driver of business growth. Our tax system needs to be structured to ensure that incentives to invest in New Zealand are correctly aligned which brings benefits for all aspects of NZ's capital – physical, human, cultural and natural capital.

KEY SUBMISSIONS

The NZVCA makes the following submissions:

Recommendation: Retain limited partnership vehicles and imputation credits system.

- The recent introduction of limited partnership vehicles into New Zealand has been instrumental in bringing our system into line with international norms. There has been a significant uptake of limited partnerships in a wide range of circumstances and has encouraged foreign investors to engage with New Zealand businesses.
- Our imputation credit system is an aspect of the tax system which New Zealand should look to retain and even expand. Removing double taxation for domestic and foreign investors is paramount to retaining more available capital for the growth of NZ business. NZVCA also supports a move toward fuller recognition of imputation and franking credits with Australia and considers that a full mutual recognition policy would enhance the move towards a Single Economic Market with Australia.

Recommendation: Introduce a business continuity test to supplement loss continuity rules.

- NZVCA recommends the introduction of a 'business continuity' test for all taxpayers which would replace or supplement the existing loss continuity rules. If this test is not adopted for all companies across the board, specific consideration should be given to adopting this type of test for start-up and growth companies.
- Start-up and growth companies are particularly likely to incur losses early in their life-cycle and it discourages investors to commit to companies which may require future capital injections from outside investors if they know they will not be able to get any future benefit from tax losses arising.

Recommendation: Review the taxation of intellectual property with a view to provide further incentives to develop and retain intellectual property in New Zealand.

- A key concern for the NZVCA is to ensure that our tax regime is appropriate to encourage investment in intellectual property in NZ. Economic growth in the developed world is becoming increasingly reliant on IP innovators who attract capital and create highly skilled jobs in the economy.
- New Zealand's current taxation of IP is in danger of being seen as penalising IP innovators. Significant progress must be made to align our regime with international norms so at the very least New Zealand's taxation of IP is seen as neutral rather than a negative factor.
- In particular the NZVCA believes that the transfer of patents outside New Zealand should not be taxable as this encourages patent to be stripped from New Zealand before any real value has been generated, taking innovation, jobs and profits out of our ecosystem earlier than might otherwise be the case.

Recommendation: New Zealand needs further tax incentives to invest in research and development

- Investment in research and development represents a significant capital risk as costs are high and there is no guarantee of a profitable return. New Zealand's tax regime currently does not provide enough incentives to carry out research and development in New Zealand.
- The NZVCA welcomes the introduction of a new research and development tax credit but believes that the system will be fundamentally flawed if the tax credit is not refundable in a timely manner.

Recommendation: If New Zealand is to adopt a capital gains tax it must be competitive internationally

- If NZ is to adopt a capital gains tax ("CGT") one of the key considerations in designing this tax should be to produce a system that is competitive internationally, and particularly with Australia. The ultimate aim and principle which the NZVCA supports is in seeking to retain and increase the availability of capital for NZ's future leading growth businesses, not stifling that availability further.
- We have outlined several features of a CGT that we believe would make it internationally competitive as well as ensuring that tax does not distort investment or reinvestment decisions over the term of an investment. These features include roll-over relief, taper relief/long-term holdings relief and concessions for certain venture capital investment.

Ultimately, a key aspect to being a supporter of NZ's future businesses and their growth, is to have consistency, simplicity and certainty as a key tenet of any regulatory policy, not just tax policy. In considering its approach to tax policy, the NZVCA reinforces to the TWG this fundamental principle to ensure that businesses are doing just that – driving NZ's future world beating businesses forward, not caught up in complex and administrative tax compliance matters.

Recommendation: The NZVCA would like to see limited partnerships and our imputation system retained

Limited partnerships

The relatively recent introduction of limited partnerships into the vehicles available for investment into New Zealand has been a significant step in aligning New Zealand's investment system with international norms. Limited partnerships are beneficial to many investors because they allow for look-through taxation through an entity that provides a liability shield. Where there are mixed investor bases, including both domestic, foreign investors, and in some cases tax exempt investors, limited partnership vehicles bring New Zealand into line with international investment norms and flexibility. Foreign sourced income derived by non-residents through limited partnerships is ignored for NZ income tax purposes, while NZ sourced income is still captured and appropriately taxed, meaning limited partnerships are an effective investment vehicle. They also allow for domestic investors to be taxed in their own right, and at their own rate, rather than under a corporate vehicle at a fixed rate, removing complexity and inefficiency in many investment scenarios, and providing significant flexibility particularly in joint venture scenarios.

While the NZVCA believes that there are a number of ways the limited partnership model could be improved in New Zealand, we believe the shift to this model has significant benefits that New Zealand is only just beginning to realise. There has been a significant uptake of limited partnerships in a wide range of circumstances and this has encouraged foreign investors to engage with New Zealand businesses. We recommend the current tax settings for limited partnerships be retained.

Imputation credits

New Zealand is one of the few countries in the world that has an imputation credit regime. The NZVCA believes that this is an innovative part of our tax system which we believe should be retained going forward. Our imputation credit system has a number of key benefits including; removing double taxation which creates a single layer of tax and encourages the pay-out of dividends; and reducing the cost of capital for investors.

The imputation system effectively eliminates double taxation domestically, and to some extent internationally, by giving shareholders a credit for the tax which has been paid by the company. As a general principle our tax system should aim to minimise double taxation as much as possible.

The NZVCA believes that the imputation regime could be improved by allowing some credits to be refundable in some situations and by improving the level of integration with the Australian franking credit system. In Australia individuals can in certain circumstances receive a refund for franking credits which exceed their taxable income. This means that imputation credits are not 'wasted' – i.e. no tax is paid that does not relate to taxable income received by the shareholder. Consideration should also be given to the question of refundability of imputation credits to domestic tax exempt investors.

The level of integration with the Australian franking credit system should also be increased. While New Zealand and Australia have adopted a trans-Tasman imputation regime, this regime is unnecessarily complex, has significant compliance obligations and provides often only modest benefits to shareholders as credits cannot be streamed. This regime could be significantly improved to allow full and mutual recognition of imputation and franking credits.

Recommendation: Introduce a business continuity test to supplement loss continuity rules.

NZVCA recommends the introduction of a 'business continuity' test for all companies which would replace or supplement the existing loss continuity rules. If this test is not adopted for all companies across the board, specific consideration should be given to adopting this type of test for start-up and growth companies.

Start-up and growth companies are particularly likely to incur losses early in their life-cycle and it discourages investors to commit to companies which may require future capital injections from outside investors if they know they will not be able to get any future benefit from tax losses arising.

Many international jurisdictions have adopted variations of the business continuity test including Australia, Canada, the United States and the United Kingdom. The test generally focusses on whether the business of the loss company has remained the same or of a similar nature throughout a set period. A business that satisfies the test is able to carry forward tax losses throughout the period it has retained business continuity regardless of any shareholding changes. In many countries (e.g. Australia) the business continuity test is an alternative test i.e. if the company fails the shareholder continuity test then it may apply the same business test.

Australia has recently modified its same business test to include a 'similar business test.' The similar business test does not require the loss company to carry on the same 'type' of business but instead focuses on:

- The extent to which the assets used by the company to generate assessable income is the same, regardless of whether the assets are producing different income;
- The extent to which current activities and operations are the same;
- Whether the 'identity' of the business has changed;
- The extent to which the changes to the business resulted from development or commercialisation of assets, products, processes, services, marketing or organisational methods of the business.

New Zealand's current loss continuity rules unfairly punish start-up and growth companies. These companies often accumulate early tax losses as they set up business operations and complete research and development on new products or services. These companies also generally require significant capital investment throughout the growth process and in order to expand into new markets or gain more market share. These capital investments may lead to a breach of the shareholder continuity threshold before the company has made any profit. Under current rules, the company's losses are forfeited and the company obtains no value for them.

Existing loss continuity rules have several negative effects for start-up and growth companies:

- High compliance costs, because recording shareholding changes can be complicated, particularly for small or new businesses with little legal or administrative experience.

- Investors are more likely to invest through structures such as look-through companies or limited partnerships where losses are able to be utilised immediately. These structures may not be best suited to the business needs and may not be well understood by the relevant shareholders.

- Investors are more likely to invest in companies which are considered 'safer' investments and/or will require fewer capital injections at later stages, because this allows investors to maintain continuity and utilise accumulated losses. This results in a loss of diversity in the type and scope of investments made into the market. Investment is driven by tax considerations rather than solely by the viability and profitability of the start-up or growth company.

- Investment is less likely to flow into certain areas, for example biotechnology. Developments in this area are extremely costly and often necessitate stages of development and which require increased investment in each stage. As a result, any early losses will be forfeited as the project passes through development.

- Medium and smaller sized investors are discouraged from investment in start-up and growth companies as they often must invest in concert with other small and medium sized investors. This makes breaches in loss continuity more likely and medium sized businesses are less able to bear the cost of loss forfeiture.

- Finally, for those founders / entrepreneurs who have started these businesses, the loss continuity rules also deter them from taking on new capital and investment into their businesses from outside investors, due to their reticence to forfeit the business losses. This impedes the growth of such businesses and results in tax being a negative factor that is considered by founders, at the very time when taking on new capital and new partners to help innovate, challenge and grow those businesses should be the only focus.

We note that the current tax regime does allow for the carry forward of certain R&D expenditure and cashing out of some R&D related losses which go some small way to mitigate the problems discussed above. However, these regimes are restricted to specific expenditure, subject to strict caps, not well understood by taxpayers and are difficult to apply.

One arguable benefit or outcome of the current loss regime is that it may encourage founders/owners/entrepreneurs to retain their business in its initial ownership structure, retaining and building more value within NZ throughout that period. Taking loss forfeiture into account, a business may be worth more to current owners on a post-tax basis than to potential purchasers. This may result in owners retaining ownership until existing losses are utilised or their business value to potential purchasers has increased substantially.

NZVCA does not consider this arguable benefit sufficient justification for the continued use of the existing shareholder continuity test. As noted in the final bullet above, tax should not be a primary driver of investment choices, particularly in an area where new capital and expertise from investors are often the key drivers of business growth and development. We run the risk of becoming a conservative, rather than fast-paced innovation environment.

More importantly, the NZVCA considers that our current loss continuity rules puts New Zealand at a disadvantage for attracting capital into new and developing areas.   Investors are easily able to move capital particularly between New Zealand and Australia and our system means they are less likely to invest in these types of ventures in New Zealand. It also has an impact on our human capital, where entrepreneurs and innovators are encouraged to go to Australia, Asia and the US as there is greater capital available there for early stage venture capital.

Recommendation: Review the taxation of intellectual property with a view to provide further incentives to develop and retain intellectual property in New Zealand

Intellectual property is becoming increasingly important in developed economies around the world. The amount of value added to economies by IP is growing and the number of jobs and opportunities created by IP-based developments is expected to continue to grow. From a human capital perspective, jobs in sectors which are reliant heavily on IP (such as technology) are highly coveted and can be extremely competitive. IP innovators are key to attract capital investment to NZ businesses and creating highly skilled jobs in the economy.

In certain industries, for example technology and design, intellectual property can be the primary source of a company's business value. Even though IP is easily moved between jurisdictions, companies in these innovative industries tend to build off one another and cluster in geographic areas such as Silicon Valley. In New Zealand we have seen a similar phenomenon in the film industry with companies flocking to Miramar as a result of Peter Jackson's leadership in the film industry and associated companies that have arisen from opportunities in this market.

It is important to establish New Zealand as a place where such IP innovations can flourish, and not be behind international jurisdictions, as once these geographical clusters of innovations are established overseas it may be more difficult to entice these types of innovations to come to New Zealand or indeed for our own innovators to stay and develop their ideas in New Zealand. It is crucial therefore for New Zealand to position itself and build a reputation as an IP innovator.

A key concern for the NZVCA therefore is to ensure that our tax regime is appropriate to encourage investment in IP in NZ. We acknowledge that tax is not the only, and in fact should not be the most influential driver of where IP innovation occurs. But that does not mean that it is not important and should not be used, in conjunction with other policy initiatives to encourage investment in IP in New Zealand. We also acknowledge that it may not be possible for New Zealand to implement a world-leading IP taxation regime, but significant progress can be made to align our regime with international norms, such that, at the very least, our regime is seen as a neutral rather than a negative factor.

New Zealand's current system runs the risk of being seen as a jurisdiction which penalises IP innovators through our tax system. This means IP will not be developed in NZ or will be moved from NZ in its infancy to other 'innovation-friendly' jurisdictions. This strips employment and development opportunities from NZ and draws highly skilled entrepreneurial individuals to leave home in search of opportunities overseas.

The introduction of certain BEPS related initiatives has meant that it is becoming increasingly difficult for companies to move IP into jurisdictions where there is no 'nexus' with their other business operations or research and development expenditure. However, in many cases companies do have operations in multiple jurisdictions or may consider the benefits of establishing operations in multiple jurisdictions as they grow and expand and so companies do still retain choices as to where they base their IP. In addition, there may be limited incentives or ability for countries to enforce 'nexus' style rules where there is an absence of any overriding body such as the European Commission which was responsible for the decision that Apple ought to pay over back-taxes to the Irish Government.

Patents

Patents provide important IP protection for many valuable innovations. Across international jurisdictions patent recognition is now available for an increasing range of products and processes, providing even greater scope for investment and development.

There has also been an increase in the number of tax related incentives / concessions on the treatment of patents. Approximately 18 countries around the world now have 'patent box' or 'innovation box' incentives which reduce the rate of corporate taxation levied on the income generated from certain types of IP including patents. Countries with patent box style laws include many European countries, the UK, India and China (although some of these systems are being modified in light of recent BEPS changes). The introduction of the UK patent box system was cited by multi-national company GlaxoSmithKline as a significant factor in its decision to build a new pharmaceutical factory in the UK in 2003. While having expanded operations significantly over the period GlaxoSmithKline had not built a new factory in the UK since the 1960s.

It is in this global context that New Zealand should consider its' rules around the taxation of patents. The NZVCA does not necessarily support the introduction of a patent box system in New Zealand. In

2016 Australia's Office of the Chief Economist investigated the option of a patent box system for Australia and was largely unconvinced that it would be beneficial. However, it is important to note that many jurisdictions around the world have significant concessions for IP innovators which we do not have in New Zealand.

New Zealand Inland Revenue has taken the view that when patents are transferred outside New Zealand, a transfer of value takes place that is taxable under ordinary principles, with patents effectively being considered as revenue account property in most cases.

The effects of this approach may far outweigh the benefits of any tax revenue collected to New Zealand. This is because this treatment encourages companies to shift patents offshore in their infancy in order to minimise their tax liability. In general, at this stage the patent has not yet accumulated a high value and as a result very little tax is collected overall. The other effect is that New Zealand loses the benefit of patents being developed and tested within our market, as this process will instead occur overseas.

We acknowledge that, even in the absence of such a tax, patents are unlikely to remain in New Zealand indefinitely, however, they would likely remain in New Zealand for a longer period, along with the associated people and investment that will have broader economic benefits. In particular, the incentives to move to countries with patent box or low tax systems only arise when the patent is actually producing income so there is not an incentive to move the patent into those jurisdictions until the very latest stage when the patent is producing significant income. This means that there is a key development period where patents may be tested and further refined which New Zealand is missing out on because of our tax treatment.

Recommendation: New Zealand needs further tax incentives to invest in research and development

By international standards, investment in research and development ("R&D") in New Zealand is low. Investment in R&D represents a significant capital risk as costs are often high and there is no guarantee of a profitable return. Even where R&D is successful, there is often a significant delay – sometimes 5 to 10 years between the investment of capital and any profitable returns. New Zealand's tax regime provides some preferential treatment for R&D companies but this does not extend far enough. From an international perspective, our tax regime provides considerably fewer incentives to carry out R&D in New Zealand.

The NZVCA believes that a system which incorporates both R&D tax credits and grant systems such as the Callaghan grants is necessary to encourage R&D investment. Two systems are beneficial because different companies have different constraints in place – for example Callaghan grants provide capital up-front which many companies may need, but they also require a certain level of specificity of the type of R&D undertaken and its' objectives which may be unsuitable in certain other situations. In those situations, a tax credit may be more appropriate.

The NZVCA welcomes the current Government's announcement of its intention to introduce a R&D tax incentive in 2019 to help more businesses undertake a greater amount of R&D. The proposed incentive (discussion document released 19 April 2018) is a 12.5% tax credit on eligible business R&D expenditure occurring in NZ from 1 April 2019.

The NZVCA will look to submit on this specific proposal to the relevant working group as invited by the discussion document. We are disappointed to see that the proposed credit is non-refundable meaning that its use will be extremely limited.

To summarise our views on R&D incentives as they currently stand, the NZVCA believes that R&D rules are unnecessarily complex and impose onerous obligations on companies, particularly those that most need the capital but are least likely to have the formal procedures and documentation in place for the likes of Callaghan grants. This further discourages companies from engaging in R&D in New Zealand over other comparable jurisdictions.

Furthermore, unless such an R&D regime can provide for timely credits and cash refunds, the long potential delays from the time of incurring such expenditure until such refunds are actually obtained means the intended benefit is far too late in many instances.

Recommendation: If New Zealand is to adopt a capital gains tax it must be competitive internationally

The NZVCA believes that one of the key considerations when reviewing our tax system is to ensure that our tax system is competitive internationally. NZ struggles to attract capital investment particularly in the venture capture area and while venture capital investment in NZ has been growing it is still below the OECD median. For NZ ensuring that our tax system is competitive with Australia in particular is important given how easy it is to transfer capital from NZ to Australia.

If NZ were to adopt a capital gains tax, the CGT should be designed with international CGT systems in mind to ensure NZ is competitive, particularly with Australia where a number of specific investment regimes and vehicles encourage investment. Minimising the impact of any leakage of available cash to the already constraint growth capital environment through the CGT environment should be paramount to any policy.

Looking internationally, we believe there are a number of features that a competitive CGT should have:

Roll-over relief

Most CGT systems around the world have some form of roll-over relief. The effect of a roll-over relief is essentially to defer or disregard the arising capital gain where the capital is used to purchase a replacement asset (which would ultimately still be subject to a capital gains tax). This means that the capital gain is not taxed until the point the gain is actually realised by the asset holder. These provisions encourage capital to be reinvested into business instead of paid out to shareholders which is beneficial to growth and business development. In Australia the roll-over provisions also provide relief in scenarios where a capital asset is legally transferred but no real change in economic ownership occurs – for example where assets owned by an individual are transferred to their wholly owned company or where shares are swapped as part of a business restructure but the shareholders underlying interest remains the same. These types of provisions are extremely important as they allow flexibility for business restructures as businesses grow and develop.

Taper relief or long-term holding reliefs

Gains arising from inflation are not 'true' capital gains and so fundamentally should not be subject to tax. Most jurisdictions with a CGT do attempt to take account of inflation in some way. Indexation (trying to calculate the effect of inflation over the period an asset was held) is very rarely used as this is extremely complex and creates uncertainty for capital holders. Australia previously had an indexation system which was replaced in 1999. Instead most countries (including the USA and Australia) apply a 'taper relief' system. Taper relief is a way of accounting for inflation by reducing either the tax rate applying to the taxable capital gain or reducing the amount of the gain, where an asset has been held for a certain period of time.

Taper relief systems around the world have varying thresholds for the taper to apply – for example in Australia for assets held longer than a year there is a 50% reduction in the taxable gain for individuals and trusts and a 33.33% reduction for superannuation entities. Other countries with a one year taper include the United States, Turkey and Chile. The United Kingdom does not have a general taper relief but it has some specific exemptions which relate to assets held for a long period.

A taper relief system is beneficial as it accounts for the effects of inflation but also encourages investors to invest on a long-term basis. Investors are most likely to consider investments where they are likely to invest over a long period of the businesses life and therefore introduce more value to that business both in terms of capital but also in terms of management or development experience.