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A Same Business Loss Carry-Forward Test for New Zealand

EXECUTIVE SUMMARY

- Tax losses incurred by a company have value to the extent they are able to be carried forward and offset against future income. Forfeiture of such losses has a cost to the company.

- Innovative companies, early-stage companies and rapidly growing companies are more likely than other companies to incur tax losses at certain stages in their life.

- Current New Zealand law requires a minimum 49% continuity of ownership for a company to carry forward tax losses. Changes of ownership, including as a result of capital injections by new investors to fund growth and development, can therefore result in forfeiture of tax losses.

- Other countries supplement their continuity of ownership test with a "same business" test, which allows a company to carry forward tax losses despite changes of ownership provided the company carries on the same type of business.

- The absence of a same business test in New Zealand results in punitive tax outcomes, distorts decision-making and disincentivises innovation, growth and risk-taking.

- Introducing a same business test would remove a barrier to growth and innovation in New Zealand, bring New Zealand law into line with international norms and is likely be fiscally positive.

1. INTRODUCTION AND CURRENT LOSS UTILISATION RULES FOR COMPANIES

1.1 Companies, like all taxpayers, are required to calculate their taxable income (and therefore their income tax liability) for each "tax year". Where a company has a positive amount of taxable income for a tax year the company has an income tax liability equal to 28% of that taxable income. Where a company has a negative amount of taxable income (ie a "tax loss") for a tax year, no income tax is payable by the company, and except in very limited circumstances[1] the company is not able to "cash out" the value of those losses with the Government by either carrying the loss back and offsetting it against a prior year's taxable income on which tax has been paid (to obtain a refund of that tax) or simply receiving an amount equal to the tax value of those losses to the company. However, the amount of that tax loss may either be:

(a) made available to another company in the same group of companies as the company (applying a minimum 66% common ownership threshold), to reduce the amount of taxable income of that other company for the income year; or

(b) carried forward to a future tax year, when it may be used to either reduce the amount of the company's taxable income in that tax year or be made available to another group company in that future tax year.

1.2 Accordingly, the ability of a company to realise the value of a tax loss is dependent on that company, or another group company, having taxable income in a future tax year. The reason given for this asymmetric treatment of profits and losses is that an ability to obtain value for tax losses that is not capped by reference to the taxable income of the corporate group would provide a strong incentive for businesses to create artificial tax losses and thereby pose a risk to the tax base.[2]

1.3 The ability of a company to carry forward tax losses and have them available for use in future tax years is also dependent on the company satisfying the continuity of ownership requirements in the Income Tax Act 2007 ("**Act**"). In short, these rules require that at least 49% of the ownership interests in the company are held by the same persons from the time the tax losses arose until the time the company is able to use them. (The lowest percentage ownership interest of each shareholder during the relevant period is used to determine whether the 49% threshold is met.) Where this minimum continuity of ownership requirement is not met (ie there is a more than 51% change in ownership of the company since the losses arose) the tax losses are forfeited.

1.4 The policy rationale behind the minimum continuity of ownership requirement is that the benefit of company tax losses should be derived (at least to the extent of 49%) by those shareholders who incurred those losses and that companies should not be able to "trade" tax losses with unrelated taxpayers.[3] If a loss-making company could effectively trade tax losses with unrelated persons by a combination of asset-stripping and change of ownership, then this would undermine the policy of not allowing the cashing-out of tax losses.

1.5 The remainder of this paper considers the adverse impacts that the current loss carry-forward rules can have on growth, innovation and risk-taking by businesses, and

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1 The Taxation (Annual Rates for 2015-16, Research and Development, and Remedial Matters) Act 2016 introduced provisions allowing a limited ability to cash out tax losses attributable to research and development expenditure for certain entities. The Act also contains limited other examples of provisions allowing the allocation of deductions or losses to prior years for certain industries (eg sections EJ 14 and IS 5 for petroleum miners).

2 See, for example, Regulatory Impact Statement relating to *Cashing-out research and development tax losses* (21 March 2014) at pp 3-4.

3 See, for example: (a) *Business Tax Policy 1991* (Hon Ruth Richardson and Hon Wyatt Creech) (30 July 1991) at pp 82-3; (b) IRD *Taxation Information Bulletin* Volume 3, No.2 (August 1991) at 12.

proposes that the continuity of ownership test be supplemented by a "same or similar business" test, which is common in other jurisdictions.

2. ISSUES ARISING AS A CONSEQUENCE OF CURRENT LOSS CARRY-FORWARD RULES

Overview

2.1 Available tax losses are regarded as an asset of a company, in that they provide a valuable benefit in the event they are used to reduce the taxable income, and therefore the tax liability, of that company or another company in the future. However, this "asset" arises only because the company has incurred deductible expenditure that has not been able to be used to reduce a tax liability in the tax year it was incurred (because the company had insufficient income). If those tax losses are forfeited because the continuity of ownership requirements are not met, the asset disappears with the effect that the deductible expenditure incurred by the company that resulted in the tax losses has not reduced, and will never reduce, a tax liability. That is the case even if taxable income is generated in the future as a direct or indirect result of that expenditure.

2.2 Forfeiture of tax losses therefore has a direct cost to a company if and to the extent that taxable income arises in the future that could have otherwise been sheltered by the losses. The potential for this cost to arise imposes a barrier to risk-taking and innovation and affects decision-making by businesses. These adverse consequences, which are summarised below, are also considered in a paper by Alex Duncan entitled *Reducing the punitive tax treatment of innovative businesses that choose to grow in New Zealand* (October 2016).

Disincentive to take risk and innovate

2.3 All business involves risk, including the risk of financial loss. Low-risk businesses will generally be less likely to generate tax losses, and where such losses do arise those losses could be expected to be offset against taxable income sooner rather than later. Higher risk businesses on the other hand are more likely to generate tax losses, and if such losses do arise it may be longer before they are able to be utilised. In addition, higher risk businesses are more likely to have changes in ownership, particularly when tax losses are arising, due to the need to attract capital investment from sources other than the current owners.

2.4 These factors combine to mean that companies that carry on riskier businesses are more likely to forfeit tax losses. As noted above, forfeiture of tax losses results in a direct cost to the company in the event that the company generates taxable income. The fact that this cost is more likely to arise in a riskier business disincentivises investment in such businesses and results in a higher required rate of return for such investment to occur. This runs counter to the Government's Business Growth Agenda, which emphasises the importance of innovation, connectivity and risk-taking.

Distortions created by current loss carry-forward rules

2.5 A number of distortions arise as a result of the current loss carry-forward rules. These distortions highlight the punitive consequences for a company if it forfeits tax losses as a result of an ownership change and result in sub-optimal business decisions being made as a result. For example:

(a) Where a business is carried on through a partnership (including a limited partnership) or a look-through company ("**LTC**"), any tax losses generated are available to be used by the partners or shareholders to offset other taxable income. However, there are material barriers to the use of the LTC and limited partnership regimes:

(i) A company qualifies to be a LTC only if it has five or fewer "look-through counted owners". Therefore, the regime is only available for closely held companies.

(ii) The limited partnership regime is complex from a governance/administrative perspective and a tax perspective when compared to a company, particularly when there are changes of ownership (which trigger a deemed sale and purchase of the underlying assets for tax purposes).

Accordingly, neither regime is practical for business that expects to introduce new owners as it grows.

(b) If the company carrying on a business that generates tax losses has other sources of income, or is in the same group as a company with taxable income, then the tax losses can be used immediately. On the other hand, a company with no other income sources and no other group companies cannot use the losses immediately and must carry them forward, subject to the risk of forfeiture. Therefore, the value of tax losses arising from a business activity depends on whether the company carrying on that business has other income sources. This means that innovation and risk-taking has different fiscal consequences for a company or corporate group with other income-producing activities than for a new-entrant or start-up.

(c) Businesses where the relative timing of income and expenditure is closely matched do not have the same risk of forfeiting losses as businesses where material expenditure is likely to be incurred in advance of revenue being generated. So even though over the life of the business the expected profits are the same, the timing differences give rise to different risks of forfeiture. This incentivises greater investment in short-term projects relative to long-term ones.

Consequences for business decision-making

2.6 A principle underlying New Zealand's tax policy framework is that tax distortions should not influence decision-making regarding the allocation of resources. However, the above discussion illustrates how the current loss carry-forward rules for companies:

(a) creates a preference for low-risk business activity and disincentivises innovation and risk-taking;

(b) creates a preference in favour of established companies with other sources of taxable income;

(c) can affect decisions regarding the timing and form of capital-raisings as the cost of forfeiting tax losses needs to be weighed against the benefits of the new capital.

2.7 The last point also raises the issue that the cost of tax loss forfeiture is borne by the existing shareholders, not the new investors, because the price that can be obtained for the investment (or acquisition) is not able to reflect the benefit of tax losses if they are, or are likely to be, forfeited. The inability to realise the value of tax losses on a full or partial sell-down of a company reduces the expected value of any return and so again disincentivises such investment. Where the new investor or purchaser is outside New

Zealand this decreases the value that New Zealand obtains for the early stage risk and innovation.

2.8 A related consequence is that the initial investors may be incentivised to locate the business, or at least the intellectual property aspect of the business, outside New Zealand, in a jurisdiction that has more accommodating tax rules.

Case studies

2.9 A number of case studies illustrating how the current loss carry-forward rules have resulted in the forfeiture of losses by companies as a result of raising capital in order to fund further investment and development are set out in Appendix One. These case studies reflect actual companies and actual transactions.

3. LOSS CARRY-FORWARD RULES IN OTHER JURISDICTIONS

3.1 Most comparable jurisdictions have a form of "same business" test as an alternative to or in substitution for the continuity of ownership test for the purposes of allowing tax losses to be carried forward. A same business test recognises that where a company continues to carry on the business activity that gave rise to the tax losses, any ownership changes are likely to have occurred for commercial reasons rather than to facilitate the trading of, or inappropriate access to, the company's tax losses. In those circumstances there is no policy reason why the losses should not be available to offset future profits of the same business activity.

3.2 Even though the owners of the company at the time the losses are used to offset taxable income may not be the same as the owners at the time the tax losses arose, it is not correct to say that the owners at the time the losses arose will not have benefited from the losses in that case. A same business test allows those owners to benefit by obtaining value for those losses through the sale price where they sell the business, or an interest in the business, to the new owners.

Australia

3.3 Australia first introduced a same business test in 1965. In December 2015 the Australian Government announced a proposal to relax its same business test by supplementing it with a more flexible "similar business" test. The reason for the proposed change is that it is considered that the current same business test is too restrictive and is stifling innovation and diversification. That is because a company is deemed to fail the same business test if it derives income from a business activity it did not previously carry on or a type of transaction it had not previously entered into, even if also carries on the same business and/or enters into the same types of transaction it did before.[4]

3.4 The proposed new "similar business" test prescribes the following three non-exhaustive factors that must be taken into account in ascertaining whether the company's current business is sufficiently similar to its former business:

(a) the extent to which the assets (including goodwill) used in its current business were also used in its former business;

(b) the extent to which the sources of income of its current business were also the sources of income of its former business; and

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[4] Income Tax Assessment Act 1997 (Cth), section 165-210(2).

(c) whether any changes to its former business are changes that would reasonably be expected to have been made to a similarly placed business.

3.5 The Explanatory Memorandum that accompanied the draft legislation for the similar business test emphasises that the focus is on the identity and character of the business, and is a question of fact. It is not sufficient, for example, that the current and former businesses are both in the hospitality sector. Instead, the test looks at the commercial operations and activities of the current business and compares them to those of the former business to determine if the businesses are sufficiently similar. Any changes should represent a natural progression or diversification of the former business, including those made in order to grow or rehabilitate the business, such that there remains a clear similarity between the essential character of the former business and the new business.

Canada, the UK and the US

3.6 Canada, the UK and the US all have same or similar business tests as an alternative to their continuity of ownership tests:

(a) In Canada losses arising from a business carried on by a company may be carried forward and deducted from income arising in future years from that business.[5]

(b) In the UK losses arising in a period before a change of ownership (as defined, but generally reflecting a change in control of 50% of the ordinary shares) may not be set off against income if:[6]

(i) there has been a major change in the nature or conduct of a trade carried on by the company within three years of the change of ownership; or

(ii) prior to the change of ownership the trade activities of the company become small or negligible and there was no significant revival until after the change in ownership.

(c) In the US prior-period losses cannot be deducted from future income following an ownership change if the company does not continue the business enterprise at all times during the two year period following the ownership change.[7] For the continuity of business enterprise test to be satisfied the purchasing company must either continue the target company's historic business or use a significant portion of the target company's historic business assets.[8]

4. PROPOSED SAME OR SIMILAR BUSINESS TEST FOR NEW ZEALAND

Objectives of a same or similar business test

4.1 A same or similar business test should:

(a) allow a company carrying on an active business to raise new share capital, or otherwise have a change in shareholding, without resulting in the forfeiture of tax losses;

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5 Income Tax Act (R.S.C., 1985), section 111(5).
6 Corporation Tax Act 2010 (UK), section 673.
7 US Internal Revenue Code § 382(c)(1).
8 US Revenue Code Regulation § 1.368-1(d).

(b) but at the same time contain tax base integrity measures that prevent the trading of tax losses between unrelated taxpayers that could otherwise undermine the current policy settings regarding the inability to cash-out tax losses.

4.2 Further, and as the Australian experience shows, the test should be flexible enough to accommodate natural or expected levels of diversification, risk-taking and innovation in products and markets without resulting in a breach of the test.

4.3 Whether a company carries on a same or similar business will inevitably be a factual inquiry, and depend on the particular type of business. It is therefore difficult to legislate a prescriptive and definitive test. However, it would be preferable for the legislation to specify factors that should be taken into account rather than remain silent on what factors are relevant. Suggested factors are as follows:

(a) the goods or services produced or supplied by the company in the course of carrying on the business;

(b) the assets (including goodwill) used by the company in the course of carrying on the business; and

(c) the source and type of income derived by the company from the business.

4.4 A suggested legislative test, reflecting these factors, is set out in Appendix Two.

Application to tax losses accumulated prior to enactment

4.5 If a same or similar business test is enacted in New Zealand as an alternative to the continuity of ownership test it will be necessary to consider the extent to which it will apply to tax losses arising in income years prior to enactment. If the test was to apply to losses of a company that had already been forfeited as a result of a change of ownership then the amendment would result in a windfall to the current owners of the relevant company.

4.6 However, there does not appear to be any reason why the amendment should not apply to tax losses arising prior to enactment that have not been forfeited under current law. Indeed, it would be consistent with the rationale behind the introduction of the same or similar business test for the current owners of such companies to be able to make decisions regarding the introduction of capital without having to factor in the cost that would otherwise arise if losses were forfeited.

4.7 Therefore, it is not proposed that the same or similar business test would be restricted in a way that meant it applied only to losses arising after introduction or enactment of the test.

4.8 It is not considered that such an approach would give rise to fiscal risk to the Government. Although the current stock of tax losses is understood to be significant,[9] it is expected that further profiling of those losses would indicate that the vast majority are in dormant entities and could not be utilised under a same business test. If there was a fiscal concern then two potential methods of addressing the concern while still allowing recent losses of active companies to be covered would be:

(a) to specifically refer to the extent of any dormant periods as being a factor to take into account when determining whether the company carries on a same or similar business to that carried on when the losses arose;

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9 The Officials' Issues Paper *R&D Tax Losses* (July 2013) states (at paragraph 2.15) that the current stock of losses for all firms was approximately $45 billion in May 2013.

(b) to limit the application of the test to losses arising after a particular date (for example 10 years prior to enactment).

4.9 The same or similar business test could also be buttressed by a specific anti-avoidance rule if necessary in order to provide additional protection to the tax base.

APPENDIX ONE: CASE STUDIES

CASE STUDY ONE: ROCKET LAB LIMITED

1. Rocket Lab Limited was founded in 2006 by Peter Beck with the vision of enabling regular and affordable access to space for the growing global small satellite industry.

2. From 2007 to 2013 Rocket Lab worked on developing is core technology, including a launch vehicle and engine, capable of delivering small satellites into orbit. During this phase the company was funded by its founder and an individual supporter/investor, and was supported in its development through partnerships with US based research agencies.

3. In 2013 Rocket Lab sought further capital in order to fund the next phase of its development. A US venture capital fund (Khosla Ventures) and Sir Stephen Tindall's K1W1 investment fund both invested at this time. In conjunction with this capital-raising a US parent company was incorporated to hold the shares in Rocket Lab Limited and a US head office was established.

4. In 2015 Rocket Lab undertook a further round of capital-raising. Khosla Ventures and K1W1 both participated again, and investments were also made by another US venture capital fund (Bessemer Venture Partners) and Lockheed Martin (a large listed US company).

5. Although Rocket Lab is now headquartered (through its parent company) in the US, the majority of its technical staff remain in New Zealand and its intended rocket launch site is in New Zealand (Mahia, on the East Coast). In 2016 MBIE commissioned Sapere Research Group to conduct an economic impact analysis of the development of a rocket industry in New Zealand, with a specific focus on Rocket Lab. Sapere's analysis concluded that the industry could contribute between $600m and $1,150m of value add to New Zealand over a 20 year period.

6. From an employment perspective the Sapere Report noted that:

   (a) as at 19 September 2016 the company had 68 staff with vacancies for 28, and was hiring 1-2 staff per week;

   (b) the expected workforce of the company in the commercialisation phase was 200-400.

7. Rocket Lab has test flights scheduled for late 2016 and expects to launch commercial payloads in 2017, with customers having pre-signed commitments for over 30 launches.

8. Rocket Lab is currently (and has been since inception) in a tax loss position, reflecting the fact that the company is not yet launching income-earning payloads, as well as the significant investment it has made in research and development. This investment has been funded by new capital rather than profits. Some of the tax losses generated in early years were forfeited as a result of its capital-raisings. Rocket Lab also has the compliance burden of monitoring the impact of capital-raisings and other ownership changes (including through its employee share plan) on its tax loss position.

CASE STUDY TWO: XERO LIMITED

1. Xero Limited was founded in 2006 by Rod Drury and Hamish Edwards. Its vision was to create a global software company from New Zealand based on the delivery over the internet of accounting software for SMEs.

2. Initial capital of $2.8 million was contributed by the founders, directors and initial employees.

3. In May 2007 the company launched an IPO to raise $15 million of new capital. The IPO was conducted at an early stage in the company's life-cycle, however this reflected the limited availability of private venture capital funding for technology companies at the time. More importantly though, it was considered that the added profile and discipline associated with being listed would bring significant credibility from a business perspective, providing confidence to customers (in particular offshore customers) and advancing the execution of the company's business plan.

4. Since 2007 Xero has invested significantly in growth, product-development and expanding into new markets. This investment has been funded by a series of capital-raisings, including:

   (a) $29 million in 2009 (from strategic investors and existing shareholders);

   (b) $4 million in 2010 (from a US based investor);

   (c) $35.6 million in 2012 ($20 million private placement and $15.6 million from existing shareholders);

   (d) $60 million in late 2012 (from US based investors);

   (e) $180 million in 2013 (from domestic and US based investors);

   (f) $147 million in 2015 (from US based investors).

5. Xero has always been (and continues to be) in a tax loss position, reflecting the significant investment it has made in growth and development, which has necessarily been funded by new capital rather than profits. As was the case for Rocket Lab, tax losses generated in early years were forfeited by Xero as a result of its capital-raisings.

6. From a compliance perspective, the company has needed to monitor and track the impact of its various capital-raisings and other off-market share transfers (including in respect of its employee share ownership schemes) on its shareholder continuity position and ability to carry forward losses. This has been a complicated exercise due to the nature and number of capital-raisings that have occurred over the years.

CASE STUDY THREE: VC FUND INVESTMENTS

Case Study Three summarises three companies into which a New Zealand Venture Capital Fund has made investments. Actual company details have been withheld for the purpose of this summary.

Company A: Electronics company

1. Company A was founded in 2003 and operates in the electronics industry. In 2006 a venture fund invested $2m for a 40% interest in the company. The investment was used by Company A to fund further development/advance to the commercialisation stage. At the same time, 20% of Company A's shares were set aside for employees as part of an employee share plan in order for the company to retain those employees and align their interests and rewards with those of the other shareholders. The founder retained a 40% shareholding.

2. This 60% change of ownership resulted in the forfeiture of approximately $4 million of tax losses that had accrued since inception.

3. In 2008 the company expanded into the US market and received an initial capital investment of US$10 million, followed by further capital rounds over the following four years that resulted in a 60% change of shareholding and all tax losses from 2006 to 2009 being forfeited.

Company B: Biotech company

4. Company B was founded by two individuals in 1998 and operates in the biotech sector. In 2000 it commenced raising capital from angel investors to fund ongoing efficacy research. In 2005 it received a $1.5 million investment from iGlobe Treasury VIF Fund for a 33% interest. This Fund provided further investment over the following three years until in 2010 the company raised an additional US$4 million from an international biotech company and other investors. As a result of the shareholding changes, $4 million of tax losses from 2000 to November 2006 have been forfeited. The amount of losses forfeited would have been greater, but, at the request of the major incoming investor, and in order to utilise accumulated losses prior to the larger capital raising, the company sold its IP to an offshore associate, with the gain on that sale offset by some of the available losses.

Company C: Environmental company

5. Company C was established by three individuals in 2014 and operates in the environmental sector. In 2015 and 2016 it received seed and A round funding totalling US$5.5 million, including US$1 million from an international venture capital fund, as well as funding from other New Zealand-based and offshore angel investors.

6. The Company will require additional B round funding of at least US$10 million in 2017 to continue its research and development. Furthermore, the company will need to raise an additional US$50 million in 2019 to build its first commercial plant and commence revenue generation in 2020. As a result of the shareholding changes arising from the additional B and C funding rounds Company C is likely to forfeit all accrued tax losses, which will exceed US$5 million. This potential loss forfeiture is of significant concern to the current shareholders who are investigating potential ways in which the losses could be preserved.

APPENDIX TWO: PROPOSED LEGISLATIVE AMENDMENTS

Section IA 5(1) shall be amended as follows:

IA 5(1) GENERAL STATEMENT A company's tax loss component is carried forward in a loss balance only if:

(a) the minimum continuity requirements of subsections (2) and (3) are met:

(b) the same or similar business requirement in subsection (3A) is met.

The tax loss component includes an unused tax loss component carried forward from an earlier income year.

New sections IA 5(3A) and IA 5(3B) are inserted as follows:

IA 5(3A) SAME OR SIMILAR BUSINESS A tax loss component is carried forward in a loss balance under section IA 3(4) only if the company carries on the same or a similar business for the continuity period.

IA 5(3B) WHETHER SAME OR SIMILAR BUSINESS CARRIED ON For the purposes of applying subsection (3A) the following factors must be considered:

(a) the extent to which the same type of goods or services are produced or supplied by the business; and

(b) the extent to which the same assets (including goodwill) are used in the business; and

(c) the extent to which the nature and sources of income from the business are the same; and

(d) the extent to which any changes to the business are those that would reasonably be expected to be made to a business of that type; and

(e) any other relevant factor.

Section IA 5(4) will be amended as follows:

IA 5(4) BREACH OF CONTINUITY OF OWNERSHIP IN PERIOD If a tax loss component cannot be carried forward because the requirements of subsections (2) and (3) are not met, and the requirement in subsection (3A) is not met, the company may apply section IP 3 (Continuity breach: tax loss components of companies carried forward) to determine whether some or all of the tax loss component is carried forward in a loss balance.

(Consequential requirements would also be required to the provisions in subpart IP dealing with the ability to use losses in respect of a part-year period when a breach occurs part way through a tax year.)