# Supplementary Order Paper to the Taxation (Annual Rates for 2020–21, Feasibility Expenditure, and Remedial Matters) Bill

*Commentary on the proposed amendments to:*

– *extend the residential property bright-line test, and*

– *loosen the loss continuity rules*

**Hon David Parker**
Minister of Revenue

First published in March 2021 by Policy and Regulatory Stewardship, Inland Revenue, PO Box 2198, Wellington 6140.

Supplementary Order Paper to the Taxation (Annual Rates for 2020–21, Feasibility Expenditure, and Remedial Matters) Bill – Commentary on the proposed amendments

ISBN 978-1-98-857324-3 (Online)



The Persistent URL for this document is https://purl.org/nzir-tp/2021-004

The document is available at
https://taxpolicy.ird.govt.nz/publications/2021/2021-commentary-arferm-bill-supplementary

## CONTENTS

# Overview

# OVERVIEW

The Supplementary Order Paper contains a number of further measures to be added to the Taxation (Annual Rates for 2020–21, Feasibility Expenditure, and Remedial Matters) Bill (the Bill).

The proposed changes:

- Extend the bright-line test that applies to residential property.
- Loosen the loss continuity rules by introducing a business continuity test.
- Turn off the deemed income rule in certain circumstances for donations of trading stock made between 17 March 2020 and 16 March 2022 (both dates inclusive), as a COVID-19 response measure.
- Further improve the administration of the Unclaimed Money Act 1971 to allow Inland Revenue to focus on reuniting owners with their unclaimed funds where there is the greatest likelihood of tracking down the owners.
- Make a number of technical amendments relating to the 39% top personal tax rate introduced in the Taxation (Income Tax Rate and Other Amendments) Act 2020.

The proposed changes would amend the Income Tax Act 2007, the Tax Administration Act 1994, the Taxation (Income Tax Rate and Other Amendments) Act 2020, and the Unclaimed Money Act 1971.

This commentary provides information on the extension to the bright-line test and the business continuity test proposal. Detailed explanations of the other items included in the Supplementary Order Paper will be made available following enactment of the Bill.

### Extension of the bright-line test on residential property

The Supplementary Order Paper proposes to extend the bright-line test, which taxes gains from residential property acquired and sold within a specified timeframe, from 5 years to 10 years.

Access to affordable housing is one of New Zealand's most persistent long-term challenges. The Organisation for Economic Co-operation and Development's (the OECD's) Better Life Index 2020 suggests New Zealanders spend the largest proportion of their disposable income on housing costs in the OECD. From 1991 to 2019 (before COVID-19), our house prices had the highest real growth in the OECD at 266 percent. In 2020, the national median house price rose by a further 19 percent, despite COVID-19.

Housing unaffordability is caused by a number of supply and demand-side factors. The proposals in this Supplementary Order Paper are a part of the Government's response to reduce investor demand for property. Decreasing the tax advantage that property investors can receive will reduce the amount investors are prepared to pay for a given house and the number of houses they will buy. The measure is intended to support first home buyers and help lift New Zealand's home ownership rates.

*Summary of key features*

- **Extension to bright-line**: the Supplementary Order Paper proposes to extend the bright-line test from 5 years to 10 years.
- **Amendments to main home exclusion**: the exclusion from the bright-line test for the "main home" would no longer apply on an all or nothing basis, but rather apply only for the period the property is actually used as the owner's main home. A 12-month change of use "buffer" is proposed, within which a change of use to or from the property being the taxpayer's main home does not need to be accounted for.
- **Amendments to the treatment of short-stay accommodation**: an amendment to the definition of "residential land" is proposed to ensure property used to provide short-stay accommodation, where the property is not the owner's main home, cannot be excluded from the bright-line test on the basis it is business premises. This amendment also ensures such properties are subject to the residential rental deduction ring-fencing rules.
- **Application date**: the 10-year bright-line test and the associated rules referred to above would apply to residential property acquired on or after 27 March 2021 except if the property was acquired as a result of an offer made by the purchaser on or before 23 March 2021, provided the offer was not able to be revoked before 27 March 2021. The amendment in respect of the residential rental deduction ring-fencing rules applies from the 2021–22 income year onwards, regardless of when the property was acquired.

**Business continuity test**

New Zealand's current loss continuity rules require at least 49% continuity of ownership of a company for losses to be carried forward to offset future taxable income. This test is an anti-avoidance measure intended to prevent loss trading. However, it can create an impediment for businesses obtaining capital in order to innovate and grow because doing so can breach the 49% threshold. While this is particularly an issue for start-ups, some businesses recovering from the economic impacts of COVID-19 will look to recapitalise and innovate in order to survive.

The Supplementary Order Paper proposes to introduce a business continuity test for loss carry forward into the Income Tax Act 2007. This test would permit a company to carry forward losses as long as there is no "major change" in the company's business activities for five years after a change in ownership. The core test is supported by specific anti-avoidance measures to ensure that the loss continuity rules are not manipulated in order to loss trade.

# Extending the bright-line test

## EXTENDING THE BRIGHT-LINE TEST

***(Clauses 5A, 13F, 25C, 33F, 37E, 37EB, 37F, 37FB, 38BA, 38BAB, 57B, 58(3B), 58(3C), 73B, 73C and 73D)***

### Summary of proposed amendment

The Supplementary Order Paper extends the bright-line test from 5 years to 10 years.

### Application date

The extended bright-line test would apply to residential land acquired on or after 27 March 2021. However, it would not apply to property acquired on or after 27 March as a result of an offer made by the purchaser on or before 23 March 2021 (the date the measures were announced), provided that that offer was not able to be revoked before 27 March 2021 – in this case, the existing bright-line period of five years would continue to apply.

### Key features

***Extended bright-line test (new section CB 6A)***

The Supplementary Order Paper proposes to extend the bright-line test, which taxes gains from residential property acquired and sold within a specified timeframe, from 5 years to 10 years. Income arising under the bright-line test is taxed at a person's marginal income tax rate.

The other policy settings for the bright-line test remain the same, except for the changes to the main home exclusion in section CB 16A and the business premises exclusion in the definition of "residential land", as outlined further in this commentary.

Therefore, the following features of the 5-year bright-line test will continue:

- The rules that determine when the property is acquired and disposed of, and when the bright-line period is counted from.
- The definition of "residential land" covered by the bright-line test includes land that has a dwelling on it, land where the owner has an arrangement to build a dwelling on it, and bare land that may be used for erecting a dwelling under the relevant operative district plan. "Residential land" does not include farmland or land used predominantly as business premises (subject to changes to ensure property used to provide short-stay accommodation is treated as residential land and not excluded as business premises – see below).
- The current exclusions and other forms of relief will continue to apply – that is:
  - the main home will continue to be excluded (subject to changes to ensure the exclusion only applies for the periods the property was used as a main home – see below)
  - transfers upon death, and any subsequent disposal by the beneficiary will continue to be exempt, and

- those who receive land under a relationship property agreement will continue to take on the bright-line start date (the date from which the bright-line period is counted) of the transferor.

- The main home exclusion is available to properties held in trust. However, people cannot use the main home exclusion for multiple properties held through trusts.
- The main home exclusion cannot be used if it has already been used twice in the two year period preceding the date of sale, and also cannot be used by a person, or group of persons, who has a regular pattern of buying and selling their main home.
- Residential land withholding tax will apply to taxable bright-line sales by anyone who is an "offshore RLWT person" (defined in section YA 1 of the Income Tax Act 2007) – in short, a vendor who is living or established outside New Zealand.
- Specific anti-avoidance rules remain, to counter companies and trusts being used to circumvent the bright-line test.
- Vendors will continue to be allowed deductions for property subject to the bright-line test according to ordinary tax rules (subject to amended deductions as a result of changes to the main home exclusion – see below).
- Losses arising from a sale under the bright-line test will remain ring-fenced so they may only be used to offset taxable gains from other land sales.

***Application date (clause 5A(2))***

The extended bright-line test would apply to property acquired on or after 27 March 2021. However, it would not apply to property acquired on or after 27 March as a result of an offer made by the purchaser on or before 23 March 2021, provided the offer could not be revoked before 27 March 2021.

An irrevocable offer is one that cannot be withdrawn before a certain time. For example, it is common as part of the tender process to sign a tender document that states the person cannot withdraw their offer until 5 working days after the tender has closed.

Table 1 outlines some scenarios and whether the 5-year or 10-year bright-line would apply.

**Table 1: Extended bright-line test application date examples**

| **Example** | **What bright-line test applies?** |
|---|---|
| *The following scenarios deal with revocable offers* | |
| Purchaser offers on 21 March 2021, seller accepts on 24 March. Sale and purchase agreement (ASAP) signed 24 March. | 5-year test applies. |
| As above, but the seller accepts the offer and signs the ASAP on 27 March. | Extended 10-year test applies. |
| Purchaser offers on 18 March 2021, seller verbally accepts on 24 March, but does not sign ASAP until 27 March. | Extended 10-year test applies (for property transactions a verbal contract is not binding, and the purchaser does not have an equitable interest in the property at that point). |

| **Example** | **What bright-line test applies?** |
|---|---|
| Purchaser offers on 19 March 2021, seller counter-offers on 24 March, purchaser accepts on 25 March. | 5-year test applies. |
| As above, but the purchaser accepts the counter-offer on 27 March. | Extended 10-year test applies. |
| *The following scenarios deal with irrevocable offers* | |
| Purchaser submits offer as part of tender process that closes on 22 March 2021. The tender document states that the offer cannot be withdrawn until 28 March. Seller accepts offer on 27 March and ASAP is signed. | 5-year test applies.<br>Although the purchaser acquires the land on 27 March and therefore is prima facie subject to the extended test, the carve-out for offers made on or before 23 March applies. |
| Purchaser submits an offer as part of a tender process that closes on 16 March 2021. The offer cannot be withdrawn until 22 March. Purchaser does not withdraw the offer, seller accepts on 27 March and ASAP is signed. | Extended test applies.<br>The carve-out does not apply because the purchaser was able to revoke their offer before 27 March. |
| *The following scenarios deal with conditional offers*[1] | |
| Purchaser submits an offer subject to a building report on 18 March 2021. The vendor accepts the offer and the ASAP is signed on 24 March. On 2 April, the purchaser informs the vendor that the condition is satisfied and the agreement goes unconditional. | 5-year test applies.<br>The purchaser acquired the land when the binding agreement (subject to conditions) was entered into on 24 March, not on 2 April when the conditions were satisfied. |
| As above, except the purchaser and seller agree on a reduced price on 2 April, each signing the change in the agreement. | 5-year test applies. The binding agreement was entered into on 24 March, which is before 27 March. |

***The 5-year bright-line test (section CZ 39)***

The 5-year bright-line test continues to apply in limited circumstances:

- to residential land acquired on or after 29 March 2018 but before 27 March 2021
- to residential land acquired on or after 27 March 2021 as a result of an offer made by the purchaser on or before 23 March 2021, if the offer could not be revoked before 27 March 2021.

The income charging provision for the 5-year bright-line test has been shifted from section CB 6A to section CZ 39.

[1] The date of acquisition (when the person first acquired an estate or interest in the land) is relevant for determining which bright-line test will apply (the 5-year or the 10-year test). The acquisition date is generally when there is a binding agreement between the purchaser and the seller. This includes when the vendor accepts an offer with standard conditions to be satisfied (such as obtaining finance or a building report), not a later date when those conditions are satisfied or settlement occurs. Note that, in most cases, a different date is relevant for calculating the person's period of ownership for the bright-line rules – the bright-line period is generally counted from the date the land is transferred under the Land Transfer Act 2017.

The current main home exclusion that applies for the purposes of the 5-year test has been shifted from section CB 16A to section CZ 40.

***Residential land withholding tax (section RL 1 of the Income Tax Act 2007 (ITA) and sections 54C–54E of the Tax Administration Act 1994 (TAA))***

Residential land withholding tax (RLWT) applies to sales of residential land made by an "offshore RLWT person" if the sale occurs within five years. This is provided for in section RL 1 of the ITA and section 54C of the TAA.

With the extension of the bright-line test from five years to ten years, sections RL 1 and 54C will be updated so that RLWT will apply to sales of residential land made within ten years of acquisition (where the acquisition occurs on or after 27 March 2021 and the irrevocable offer carve-out does not apply).

Section RL 1(2)(a) is being updated to include references to new sections CZ 39 and CZ 40, so that a five-year test will still be relevant for properties acquired before the application date of the 10-year test.

Section 54E of the TAA provides that the Commissioner is able to issue an RLWT exemption certificate in limited circumstances – including where a seller is in the business of developing land, dividing land into lots, or erecting buildings; and where the property was the seller's main home.

RLWT exemption certificates will continue to be available where a property is used as a main home:

- For properties acquired before 27 March 2021 (or subject to the irrevocable offer carve-out), this will be where it was the owner's main home for more than 50 percent of the bright-line period (in current CB 16A which will become new section CZ 40).
- For properties acquired on or after 27 March 2021 (excluding where the irrevocable offer carve-out applies), this will only be where it is used as the owner's main home for the whole bright-line period, including days within the 12-month buffer that are counted as main home days (provided for in proposed new section CB 16A).

The Supplementary Order Paper proposes to amend section 54E of the TAA to refer to both section CB 16A and proposed new section CZ 40 of the ITA (that is, both versions of the main home exclusion).

Where RLWT has been withheld, section 54D of the TAA and section RL 6 of the ITA permit a taxpayer to file a form for their land transactions to obtain a refund if too much RLWT has been paid relative to their overall income tax liability for their land transactions. The Supplementary Order Paper proposes to update section 54D to refer to both CB 16A and proposed new CZ 40.

Questions on the appropriateness of the RLWT settings more generally were not considered as part of this exercise. These may be considered as part of future work in the area.

## AMENDMENTS TO THE MAIN HOME EXCLUSION

***(Clauses 5A, 5, 13F, 14B, 58(10ABA), 58(12BAB), 58(3B), 58(3C) and 58(3D))***

### Summary of proposed amendment

The Supplementary Order Paper amends the "main home exclusion" from the bright-line test so that it no longer applies on an all or nothing basis, but rather applies only for the period the property is actually used as the owner's main home. A 12-month buffer is proposed to allow the property to not be used as a main home without tax implications.

### Application date

The amended main home exclusion applies to property subject to the 10-year bright-line test. That is, property acquired on or after 27 March 2021. However, it does not apply to property acquired on or after 27 March 2021 as a result of an offer made by the purchaser on or before 23 March 2021, provided the offer could not be revoked before 27 March 2021. The existing main home exclusion will continue to apply for such properties, as well as properties acquired before 27 March 2021.

### Key features

- The main home exclusion is being amended so that it no longer applies on an all or nothing basis. Instead, it will only apply for the period(s) the property is actually used as the taxpayer's main home. To be within the exclusion, there is still a requirement that the property has been used predominantly (on a floor area basis) as the taxpayer's main home.
- The proposed legislation provides that a property is excluded from the bright-line test if it is the owner's main home for the full bright-line period. Days when the property is not used as the main home will be treated as main home days if:
  - the non-main home days are in a period of non-main home days of 365 days or less (the counted period), and
  - the counted period is immediately before or after a period where the property is the person's main home.

  The effect of this is that there is a 12-month buffer, within which a change of use of a property to or from being the taxpayer's main home would not need to be accounted for. In other words, the main home exclusion would still apply if the property was not used as a main home for periods of less than 12 months at a time. If the period that the property was not used as a main home exceeds 12-months, the main home exclusion will not apply.
- If the full main home exclusion in proposed new section CB 16A does not apply, the amount the person derives from selling the property is income under section CB 6A. However, if the property has been used as the main home for some of the time it was owned, the proposed legislation provides that the taxpayer is required to pay tax only for periods where the property was not used as their main home, or not counted as their main home. Periods of 12-months or less where the property is not used as a main

home will be counted as main home days for the purposes of the calculation. The proposed legislation provides for this as follows:

- New section CB 6A(6) provides that if the person has excluded days (that is, main home days) in the bright-line period, the amount of income the person derives from disposing of the land is reduced by reference to the formula in section CB 6A(7).
- New section CB 6A(7) provides that the person's income is reduced by the amount calculated by subtracting the value attributable to the period the property was used as a main home or counted as a main home (that is, the proportion of days the property was used/counted as a main home multiplied by sales price) from the sale price. This ensures that the taxpayer only has income attributable to the days the property was not their main home (provided the days are a period of more than 12 months).
- New section DB 23C reduces the deduction the taxpayer can claim for the cost of the property (which includes the acquisition cost and any capital improvements), so that the deduction is only allowed for the period the property was not used as the main home (as this is the period in respect of which the gain is taxed).

**Background**

A person's main home is not taxed under the bright-line test. Under current law the property is either fully in or fully out of the main home exclusion. For example, a person can currently qualify for the main home exclusion where the property is rented out for some of the time it is owned, provided it is used as the owner's main home for more than 50 percent of the bright-line period. This all-or-nothing approach is simple and easy to apply, and made sense in the context of a shorter bright-line period. However, it would not be appropriate with a longer bright-line test as much more income could be involved. For example, without any changes to the way the main home exclusion works, a person would not have to pay tax under the bright-line test for a property that was rented out for four years if it was used as the taxpayer's main home for five years.

**Detailed analysis**

***Main home exclusion (new section CB 16A)***

The Supplementary Order Paper proposes to amend the main home exclusion so that it no longer applies on an all-or-nothing basis in relation to residential land acquired on or after 27 March 2021 (subject to the carve-out for irrevocable offers). The existing main home exclusion would continue to apply to properties acquired before the application date (or after but subject to the irrevocable offer carve-out). This has been shifted to proposed new section CZ 40. Table 2 outlines the existing section and the proposed change.

**Table 2: Existing sections and proposed changes**

| Current law | Proposed change |
|---|---|
| CB 16A: Section CB 6A does not apply to a person who disposes of residential land if, **for most of the period** [the bright-line period],[2] the land has been used predominantly for a dwelling that was the main home for the person… | Proposed new section CB 16A: Section CB 6A does not apply to a person who disposes of residential land if, **for all of the days** [in the bright-line period], the land has been used predominantly for a dwelling that was the main home for the person… |
| Section YA 1 definition of main home: means, for a person, the 1 dwelling – (a) That is **mainly** used as a residence by the person…. | Section YA 1 definition of main home: means, for a person, the 1 dwelling – (a) That is used as a residence by the person… |

**Example 1: Main home exclusion**

William purchased a property in 2023. He lived in it for five years and rented it for four years before selling it in 2032.

William would qualify for the main home exclusion if the current settings for the exclusion were not changed because for most of the bright-line period (that is, more than 50 percent) the house was used as William's main home. As a result, section CB 6A would not apply and William would have no tax to pay (though other aspects of the land sale rules, including the intention test, may still apply).

Under the proposed change, the main home exclusion would not apply as it was not William's main home for the full bright-line period. Instead, William would be subject to section CB 6A, but his income would be reduced to reflect the period for which the property was used as his main home (see quantification section below).

**Example 2: Main home exclusion**

Erica purchased a property in 2022. She lived in it with a flatmate until she sold it in 2027.

Under both the current law and the proposed change, the main home exclusion would apply. This is because for all of the bright-line period the property was used predominantly as Erica's main home. The "predominantly" test looks at whether, on a floor area basis, the property was used at least 50 percent as the person's main home.

*12-month buffer (new section CB 16A(6))*

Despite the requirement that the property must be used as the person's main home for "all of the days" in the bright-line period, a 12-month buffer is proposed under which any period of up to 12 months that the property is not used as the person's main home is counted as a main home period, provided the period is immediately before or after a period during which the property was used as their main home. Therefore, the property would still qualify as the person's main home if it was vacant or rented out for a period of less than 12 months before or after main home use.

This is intended to provide leeway for moving in or out of a property (for example, there may be vacant periods between settlement and moving in, or between moving out and sale). It would also cover periods of up to 12 months where the taxpayer is not using the property

[2] The bright-line period typically starts on the day the property is transferred to the owner and ends on the day the property is sold (when the sale and purchase agreement is entered into – not when the sale is settled).

as their main home (for example, if they rented the property out while overseas and it was no longer their main home for that period).

If a period of non-main home use exceeds 12 months, the entire period for which the property was not used as a main home would be subject to tax.

If the main home exclusion does not apply to take the property completely outside the bright-line test (that is, because there was a non-main home period that exceeded 12 months), any non-main home period exceeding 12 months will need to be taken into account in working out a taxpayer's income. See quantification section below.

**Example 3: 12-month buffer does not apply**

Catherine purchased her home in 2023. She lived in it until she went on her OE from 2025 to 2027. When she returned, she lived in her home again until she sold it in 2030.

The 12-month buffer does not apply here as the single period that the property was not used as Catherine's main home (2025 to 2027) exceeds 12 months. As a result, the main home exclusion does not apply and Catherine must calculate her income under section CB 6A(6) (see quantification section below.)

**Example 4: 12-month buffer applies**

Gerald purchased his home in January 2022. He did not move in until six months later as he was overseas. He sold the property in 2026.

The 12-month buffer applies as the period Gerald was overseas and not using the property as his main home was less than 12 months, and it was immediately followed by a period where Gerald used the property as his main home. Therefore, the main home exclusion applies despite Gerald not actually using the property as his main home for a 6-month period.

### *Quantification (new section CB 6A(6))*

Proposed new section CB 6A(6) would apply if a person has used their property as their main home for some but not all of the time it is held. Under section CB 6A(6), the person's income from the disposal of the property is reduced by the excluded adjustment amount that is the amount calculated under subsection (7):

$$Income\ from\ disposal - excluded\ adjustment\ amount$$

This formula only needs to be used if the property is used as the person's main home for some of the time it was owned. If the property is never used as the person's main home, the person's income is simply the amount they derive from disposing of the property. These persons are not required to apply the formula as it does not impact them.

### *Quantification formula (CB 6A(7) to (11))*

The formula for the *excluded adjustment amount* in proposed section CB 6A(7) is:

$$\frac{Adjustment\ days}{Total\ days} \times Unadjusted\ amount$$

*Adjustment days* is the total number of days during the bright-line period where the property was used as a main home. It also includes days that are counted as main home days because the 12-month buffer applies.

*Total days* is the total number of days in the bright-line period.

*Unadjusted amount* is the amount of income the person derived from disposing of the property.

The effect of this formula is to evenly apportion the sale proceeds from the property over the period it is held. The amount attributable to the period the property was not used as the taxpayer's main home then becomes income for tax purposes. There is no option to pay tax based on the actual valuations of the property at the start and end of the period the property was not the taxpayer's main home. The following examples illustrate how the formula works:

**Example 5: Apportionment following change of use**

Everly bought a property for $1 million. It was transferred to her on 13 March 2030. She sold the property on 31 December 2037 for $1.8 million. She lived in the property and it was her main home from 13 March 2030 until 28 June 2035. Everly then rented it out until 31 December 2037. Her income is calculated as follows:

Excluded adjustment amount in subsection (7):

$$\frac{1934}{2851} \times \$1.8 \text{ million } = \$1{,}221{,}045.25$$

Under subsection (6):

$$\$1.8 \text{ million } - \$1{,}221{,}045.25 = \$578{,}954.75$$

Therefore $578,954.75 is Everly's gross income from the sale. A portion of the acquisition cost needs to be deducted to determine the net amount of income from the sale that is subject to tax (see below).

**Example 6: Apportionment and the 12-month buffer**

Shanti bought a property for $700,000. It was transferred to her on 20 May 2025. She lived in it from then until 2027, when she went overseas for nine months. While Shanti was overseas, the property was not her main home. When she returned, she lived in the property until 22 March 2029. Tenants moved in a few weeks later and Shanti rented the property out until 9 November 2033 when she sold it for $1 million.

The days in the 9-month period when Shanti went overseas are counted as "main home" days, even though the full main home exclusion does not apply to her because she exceeded the 12-month buffer period when she no longer used the property as her main home (from the day after she moved out (23 March 2029) until when she sold the property on 9 November 2033).

The total number of days between 20 May 2025 and 9 November 2033 (inclusive) is 3,096. Her main home days total 1,403 (between 20 May 2025 and 22 March 2029, inclusive). For the purposes of the formula, total days is 3,096 and adjustment days is 1,403. The unadjusted amount (the amount derived on the sale) is $1 million.

Shanti's bright-line income is calculated as follows:

Excluded adjustment amount:

$$\frac{1403}{3096} \times \$1 \text{ million} = \$453{,}165.37$$

Gross income from the sale per proposed CB 6A(6):

$$\$1 \text{ million} - \$453{,}165.37 = \$546{,}834.63$$

Shanti's gross income from the sale is $546,834.63. A portion of Shanti's acquisition cost needs to be deducted to determine the net amount of income subject to tax (see below).

### *Cost of some residential land reduced (DB 23C)*

A person can claim a deduction for the cost of property subject to the bright-line test under section DB 23.

Where proposed new section CB 6A(6) applies, proposed new section DB 23C reduces the deduction that can be claimed under section DB 23 as follows:

$$Excluded\ adjustment\ amount = \frac{Adjustment\ days}{total\ days} \times cost$$

Adjustment days and total days have the same meaning as in CB 6A. Cost means the cost of the residential land.

**Example 5 continued: Cost of residential land reduced**

Continuing with Example 5 (Everly), Everly bought the residential land for $1 million, and it was transferred to her on 13 March 2030. Her total days is 2,851 and her adjustment days is 1,934.

Using the formula in proposed section DB 23C(2), Everly's excluded adjustment amount is:

$$\frac{1934}{2851} \times \$1\text{ million} = \$678{,}358.47$$

Under proposed DB 23C(1), Everly's deduction for the cost of revenue account property under section DB 23 will be:

$$\$1\text{ million} - \$678{,}358.47 = \$321{,}641.53$$

### *Combined impact of proposed new CB 6A and DB 23C*

The Income Tax Act 2007 operates on a gross basis and the structure of income charging and deduction provisions in different subparts does not allow for the provision of one single mathematical formula. However, it is possible to mathematically simplify the formula as follows:

$$(disposal\ price - cost\ of\ the\ property) \times \frac{total\ days - adjustment\ days}{total\ days}$$

**Example 5 continued: Combined effect of CB 6A and DB 23C**

Continuing with Example 5 (Everly), Everly's income under section CB 6A is $578,954.75 and her deduction for the cost of revenue account property under section DB 23 (and DB 23C) is $321,641.53. Her net income from the sale is therefore:

$$\$578{,}954.75 - \$321{,}641.53 = \$257{,}313.22$$

Everly would therefore pay tax at her marginal rate on $257,313.22.

Alternatively, using the mathematically simplified formula from above and the original information from Example 5:

$$(\$1{,}800{,}000 - \$1{,}000{,}000) \times \frac{2851 - 1934}{2851}$$

$$= \$800{,}000 \times \frac{917}{2851}$$

$$= \$257{,}313.22$$

## TREATMENT OF SHORT-STAY ACCOMMODATION

***(Clauses 58(12BAC) and 58(16))***

### Summary of proposed amendment

The Supplementary Order Paper proposes to amend the “business premises exclusion” in the definition of “residential land” to ensure that residential property used to provide short-stay accommodation, where the accommodation is provided in a dwelling that is not the owner’s main home, is subject to the bright-line test. The amendment will also ensure short-stay accommodation is subject to the residential rental deduction ring-fencing rules in subpart EL of the Act.

### Application date

***Bright-line test***

The amendment to the business premises exclusion from the bright-line test applies to property acquired on or after 27 March 2021. It does not apply to property acquired on or after 27 March 2021 as a result of an offer made by the purchaser on or before 23 March 2021, provided that offer could not be revoked before 27 March 2021. The existing business premises exclusion will continue to apply for such properties, as well as properties acquired before 27 March 2021.

***Residential rental deduction ring-fencing rules***

The amendment in respect of the residential rental deduction ring-fencing rules applies from the 2021–22 income year onwards, regardless of when the property was acquired.

### Background

The bright-line test and residential rental deduction ring-fencing rules apply to “residential land” as defined in section YA 1. “Residential land” does not include land used predominately as business premises. It was not intended that a residential property used to provide short-stay accommodation via predominantly digital platforms as part of the sharing economy should be able to potentially qualify for the business premises exclusion and therefore be out of scope of the bright-line test and residential rental deduction ring-fencing rules.

However, due to interpretive uncertainty this is not currently clear and a difference in tax treatment could distort a person’s decision to rent a property out on a long-term basis or list the property using a digital short-stay accommodation platform.

## Key features

### *Bright-line changes (paragraph (b) of the definition of "residential land")*

The Supplementary Order Paper proposes to amend the definition of "residential land" to include land with a dwelling on it, if it is used predominantly for a business of supplying accommodation and the dwelling is not the main home of the owner.

This is intended to ensure the bright-line test applies to short-stay accommodation properties (including a property that is rented out as part of the sharing economy on digital platforms, or a bach that is sometimes rented out when the owner does not use it) unless it is a bed and breakfast type facility where it is also the owner's main home and they rent out rooms for short-stay accommodation. This ensures that the treatment is the same between a person who rents out a property on a long-term basis (that is, has tenants) and a person who rents out a property on a short-term basis – that is, both are subject to the bright-line test. There is a carve-out for bed and breakfast type properties (that is, where it is the owner's main home) to ensure they are treated the same as a homeowner who rents spare rooms to flatmates – that is, neither are subject to the bright-line test. This is necessary because in a bed and breakfast situation the property may not be used predominantly as the owner's main home.

### *Residential rental deduction ring-fencing (paragraph (b) of the definition of "residential land")*

The amendment to the definition of "residential land" discussed above also ensures that residential properties used to provide short-stay accommodation are subject to the residential rental deduction ring-fencing rules.

### *Hotels, motels and other commercial accommodation*

Hotels, motels and other similar commercial accommodation are not "residential land" and are therefore not subject to the bright-line test or the residential rental deduction ring-fencing rules. This is because they are specifically excluded from the definition of "dwelling" in the Income Tax Act and the Supplementary Order Paper does not propose to change this treatment.

# Business continuity test

## BUSINESS CONTINUITY TEST

***(Clauses 16B, 25B, 28, 37E, 37F, 37H, 37I, 44DB to 44DU, 44FB, 44FC, 45B, 58(2B), 58(5CB), 58(CC), 58(10BA), 58(10BAB), 58(10BAC), 58(12BA) and 58(12C))***

### Summary of proposed amendment

The proposed amendments would introduce a business continuity test to the Income Tax Act 2007 to loosen the loss continuity rules to help stimulate growth and innovation in the economy. The business continuity test would act as a secondary test permitting loss carry forward if there is a breach in ownership continuity of a company as long as there is no major change in the nature of the business activities of the company. The test would be accompanied by measures to support the policy objective:

- A purpose provision setting out the objective of the test (promote growth and innovation while preventing loss trading).
- Exclusion of dormant companies from the rules.
- Anti-injection rules to prevent schemes that would permit the purchaser of a company to use up losses by diverting income into the company or by reducing expenditure of the company.
- A rule to stop pre-emptive changes to the business being made before the change in ownership to defeat the purpose of the business continuity test.
- Maintaining the current approach to loss grouping.

### Application date

The proposed amendment would apply to breaches of ownership continuity occurring in the 2020–21 and later income years and to losses arising from the 2013–14 income year onwards.

### Key features

Subpart IA of the Income Tax Act 2007 sets out the rules for when tax losses may be carried forward to a later income year to offset future income (the “loss continuity” rules) by requiring at least a 49 percent continuity of ownership from when a loss arises to when it is used. Proposed new subpart IB would provide an alternative loss continuity rule by introducing a business continuity test modelled on Australia’s “similar” business test. This would allow a company to carry losses forward after a breach of the 49 percent shareholder continuity rule as long as the business fundamentally continues without major change.

Australia’s similar business test compares the similarity of the business immediately before the change in ownership to the business at the time losses are used. This comparison is made by evaluating the extent to which the assets, activities, operations, and identity of the business remain the same throughout this period. Some allowance is made for changes in these factors through natural development (changes which are normal and expected of a business seeking to maximise profits).

The business continuity test proposed as subpart IB starts with the presumption that a company can carry forward losses following a change in ownership unless there is a major change in the nature of its business activities, having regard to the assets used, within five years (or less if losses are used earlier) of the change in ownership. The proposal carves out changes which are just a consequence of natural development. As a whole, the test is intended to focus on the inputs a company employs and not its outputs to allow a business to pivot. The test specifically requires reference to assets as these are a key resource which a company uses to generate income and a significant change in the asset base could be a good indication that the fundamental business activities are not being continued post acquisition and there has been a major change.

If a company is carrying forward losses comprising 50 percent or more bad debt deductions claimed under section DB 31(3) of the Income Tax Act 2007 the five-year rule will not apply. Instead, the continuity period for these companies will run from the time immediately before the breaching change in ownership until the time the loss is used up. This feature is designed to prevent failed finance type companies from being acquired for loss trading purposes.

To support the test and ensure it is not manipulated to enable loss trading the following measures are proposed:

- A purpose provision setting out the objective of the test (that is, permit capital raising while preventing loss trading).
- Exclusion of companies where the scale of activities in its business have reduced to nothing or almost nothing (dormant or “zombie” companies) from the rules.
- Anti-injection rules to prevent schemes that would permit the purchaser of a company to use up losses by diverting income into the company or by reducing expenditure of the company.
- A rule to stop pre-emptive changes to the business being made before the change in ownership to defeat the purpose of the business continuity test.
- Maintaining the current approach to loss grouping. Companies acquired as part of a corporate group may continue to offset losses within that group, however, a company cannot be purchased and have its losses made available within a new group.

**Background**

Loss continuity rules in subpart IA 5 of the Income Tax Act 2007 determine whether a company can carry tax losses forward to offset income in a future year. New Zealand’s current loss continuity rules require 49 percent continuity of ownership. This was designed to guard against loss trading but can be an impediment to businesses obtaining capital to innovate and grow because, in doing so, they can breach the 49 percent threshold. While this is particularly an issue for start-ups, some businesses recovering from the economic impacts of COVID-19 may look to recapitalise and innovate in order to survive.

**Example 7: Anonymised real-life example**

Starting Today Limited (STL) was founded in 2003 and operates in the electronics industry. In 2006, a venture fund invested $2 million for a 40% interest in the company.

The investment was used by STL to fund further development to advance to the commercialisation stage. At the same time, 20% of STL'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 other shareholders. The founder retained a 40% shareholding.

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

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, $6 million, from 2006 to 2009 being forfeited.

In September 2019, the Government committed to publicly consulting on options to loosen the loss continuity rules to address the impediment with a view to increasing the productivity of the economy.

On 15 April 2020, the Government announced that it would introduce a business continuity test modelled on Australia's "similar business" test. While the Government had planned to loosen the tax loss continuity rules following a full consultation process a decision was made to accelerate work on the business continuity test as a COVID-19 response. It was announced that the test would be introduced after consultation with private sector representatives and apply retrospectively to the 2020–21 income year onwards so that taxpayers could capital raise in reliance on being able to carry some or all of their losses forward even if the change in ownership exceeds the 49 percent loss continuity threshold.

A business continuity test works by assuming that if a business is carried on after a change in ownership the motivation for acquiring a company is a genuine commercial one. If the business is not so carried on, the motivation for acquiring the company could be loss trading (that is, acquiring a company with historic losses in order to reduce tax payable in relation to another business). The test works to prevent losses from being carried forward if loss trading could be the reason a company is acquired. The proposed changes remove an impediment to sensible business reorganisations, including recapitalisations while preventing loss trading.

The details of the business continuity test have been developed with Chartered Accountants Australia and New Zealand, the Corporate Taxpayers Group, and members of the New Zealand Law Society Tax Law Committee.

## Detailed analysis

### *Purpose*

The proposed amendments would introduce the business continuity test as new subpart IB (Carrying forward companies' loss balances: continuity of business activities) of the Income Tax Act 2007. The business continuity test is intended to loosen the current loss continuity rules so that a taxpayer can carry forward tax losses even where there has been a breach in ownership continuity.

Proposed section IB 1 sets out the purpose of the business continuity test. This is to permit loss carry forward after a change in ownership in order to remove impediments to:

- innovation and economic growth
- corporate reorganisations
- changes in the direct or indirect ownership of companies
- companies accessing new sources of share capital
- corporate reorganisations (including changes in shareholding with no immediate sourcing of new capital), and
- companies adapting their businesses in order to grow or be resilient.

Importantly, the proposed section also makes clear that loosening the loss continuity rules by introducing this test is not to encourage loss trading.

Loss trading is where there is little or no economic basis for the transaction in which a company is acquired. Its principal purpose is the purchase of losses that would otherwise not be used. This is done to offset income that the acquirer would otherwise have needed to pay tax on. Preventing loss trading is the reason loss continuity rules are part of the tax system.

Overall, the purpose statement is designed to provide context to support the interpretation and application of the business continuity test, it is not itself a test for loss carry forward. It is expected that the proposed purpose statement would have value in cases at the margin where it is unclear how the proposed business continuity test will apply.

***Core test***

Proposed section IB 3 introduces the core business continuity test. This test can be relied on to carry losses forward if a company breaches the 49 percent ownership continuity threshold, as long as there is no major change in the company's business activities that would suggest it is not being continued post-acquisition. The test would apply to all companies with the exception of mineral mining companies. There is tailored business continuity test already available to these companies in section IS 2 of the Income Tax Act 2007. Clause 44DU makes this treatment clear.

*Similar business: no major change*

A company will meet the business continuity test as long as there is no major change in the nature of the business activities carried on by the company (proposed subsection (2)(c)). In determining whether a particular change is a major change in the nature of the business activities the taxpayer would need to evaluate the extent to which the same business activities are undertaken to generate assessable income. Proposed subsection (4) specifically directs the taxpayer, to consider the extent to which the same or similar assets are used to generate assessable income.

The phrase "business activities" is intended to consider the particular actions carried out by the business to generate income and the processes or methods by which they are carried out. For example, a bakery may predominantly bake its own products for sale, but may also buy in some specialty items that it resells. Likewise, the bakery may sell its products through its own retail outlet but may also sell direct to local supermarkets and cafes.

The use of the phrase "business activities" is intended to deal with the situation where a company discontinues one business and starts another. It is normal for a company to establish new businesses as part of its growth. Absent a change in ownership a company is permitted to do this while maintaining their losses and using them to offset income of both the old and the new businesses. The business continuity test also permits this as long as the starting of a new business is something that could reasonably be expected to have happened without a shareholding change. The test is not intended to be applied granularly on a business-by-business basis.

Overall, elements to evaluate include:

- the business processes
- the scale of business activities
- use of suppliers or other inputs
- the markets supplied to
- the type of products or services supplied, and
- the assets used.

"Assets" is intended to take an ordinary meaning and includes tangible and intangible (for example, goodwill) assets. It is accepted that some categories of asset require replacement. The phrase "same or similar assets" is used to clarify that the normal replacement of specific assets with similar assets would not be part of the assessment of whether there has been a major change.

**Example 8**

If I Can Dream CGI Limited (I Can Dream) is a start-up company that produces CGI effects for television and movies. It has been operating for a number of years now and has had a number of successful projects. However, it really needs a cash injection from a new investor to take the business to the next level. It is in desperate need to update its ageing computer equipment to state of the art technology. The computer equipment represents around 95% of the assets of the company.

Largely due to the initial cost of setting up a CGI effects company, I Can Dream has been in a loss position for a number of years and Kelvin, the owner, looks for a new investor. Ben has an interest in the film industry and decides to invest in the company, however, he wants to take a controlling interest due to some question as to Kelvin's ability to run the company efficiently. After much discussion Kelvin agrees to an investment which will give Ben a 55% ownership stake in the company.

Shortly after the share subscription, I Can Dream uses the additional funds to completely replace its assets with new cutting-edge computer equipment. The equipment essentially produces the same product, but the quality has increased significantly.

Kelvin is concerned that the replacement of the assets will be a major change for the purposes of the business continuity test. For the purposes of assessing whether there has been a major change, section IB 3(4) requires a taxpayer to assess the extent to which the assets used in deriving the company's assessable income have changed during the continuity period.

In the case of I Can Dream the company has replaced all of its assets, however, those assets are essentially the same as the old assets albeit newer and shinier. The assets do the same functions as the old ones but in a more efficient way, producing a better product and they look better in the office.

The policy intent is that such a replacement of assets with new versions of essentially the same assets should not be considered as a factor when evaluating if there has been a major change.

Not every change will be a major change. Any change in business activities (including use of assets) must be considered against the unchanged business activities (including use of assets) employed by the company to generate income to establish whether the change is "major". Generally, this is a question of scale (in other words, how significant is the change in the context of the operations of the entire company). The test is not intended to give special weight to any particular factor.

**Example 9**

Flip Flop and Fly Eggs (FFF Eggs) has been producing eggs to supply to supermarkets for 20 years. The eggs have always come from battery farmed chickens. Over the last 20 years this operation has become large scale with two large sheds, containing 45,000 chickens each, occupying the land.

Consumers have started to become more conscious of the source of their food and the demand for battery eggs falls. Consumers prove to be more interested in animal welfare than in saving a few dollars per tray of eggs. FFF Eggs finds itself sustaining losses several years in a row as supermarkets buy less of their eggs and offer a lower price. FFF Eggs realises that it needs to change and decides to chase the free-range egg market. This requires an overhaul of its farm at a significant cost. A new investor is brought in who is keen to see the business become focused on animal welfare first. Ownership continuity is breached.

The battery sheds are torn down and in their place grass is seeded, a roosting barn set up and a fence erected around the land. 60,000 chickens are given to rescue centres. This leaves the 30,000 chickens the land can support free-range. This dramatically reduces the number of eggs FFF Eggs can supply, but it is able to double its price.

FFF Eggs can carry forward its pre-breach losses because, while a significant portion of the assets have changed, when weighting other factors there has not been a major change in the nature of the business activities. FFF Eggs has changed some but not all business processes, it still supplies to the same market (supermarkets and consumers of eggs), it uses the same suppliers to get chicken feed and replacement chickens, and there is no change in the type of product it is supplying.

Proposed subsection (2)(a) limits the application of the business continuity test to losses arising from the 2013–14 income year onwards. It will also not apply if the company ceases to carry on business activities during the continuity period (subsection (2)(b)).

*Carve-outs from major change*

The proposed test is designed around the fact that changes to the inputs used to generate income indicates that the fundamental business is not being continued. However, some changes to business activities and assets will be a consequence of natural development that could have happened absent the change in ownership. This behaviour is not about tax but about a company being able to position its resources in a way that maximises returns. Where there is no loss trading motivation and the fundamental business is continued the business continuity test should allow losses to carry forward. Tax should not be a barrier to normal business development.

To recognise this, proposed subsection (5) includes a number of carve-outs from what might be considered a "major change". These carve-outs are intended to permit loss carry forward in spite of a major change where there is a genuine commercial reason for changing business activities or assets that is not related to the availability of losses. The carve-outs are not a list that defines what a major change is and only need to be referred to if there is a major change. In combination with the core major change test, the carve-outs ensure that the business continuity test has the intended input focus.

The first carve-out covers changes made to increase the efficiency of the business activities. This contemplates changes that are made to decrease costs (without artificially moving costs, refer to proposed section GB 3BAC) or otherwise increase the efficiency of the company.

The second carve-out covers changes made to keep pace with developing technology. This contemplates situations, for example, where companies take advantage of new technology that becomes available or switch from a physical store to online.

**Example 10**

Maowang Chan has developed a method to identify purebred cats from imposter breeds. This is important in the competitive world of exhibiting cats. His method uses a unique barcode that is tattooed at the base of the tail of the cat to identify the breeder of the cat and the family tree of the particular cat. This barcode is then read by a scanner and the code is located in a database of cat pedigree.

His company Go-Cat-Go Limited (GCG) supplies the cat identification service which breeders use like a virtual certificate of a cat's pedigree. The company both tattoos the cats and maintains the database.

GCG has enjoyed some success with cat breeders, however, some breeders don't like this method of identification as it is invasive on the cats and the barcode can only be read by shaving off some of the fur which makes it limited to appeals from competitions where someone suspects a non-purebred cat has been awarded a prize.

Maowang wants to investigate other means of identifying the cats which are less invasive and make better use of technology. However, as the company has been incurring losses over the last few years, he needs a partner to help with funding the new ideas.

Alex is a cat lover who has previously exhibited his 12 cats and sees a great opportunity to make some money from the ideas that Maowang has. He offers to invest in GCG and Maowang sells Alex 52% of his company which breaches shareholder continuity.

In the year after the breach GCG works on developing a new technology which involves inserting a new microchip designed by GCG into the cats which can be read with a new patented scanner which GCG has manufactured. This has involved GCG replacing its old tattoo equipment with the new electronic scanners and microchip manufacturing equipment. The scanners and microchips are then sold to vets, who place the chips into client's cats and can search them on the database on request. In that year GCG looks to use some of the tax losses brought forward after the breach.

GCG has had a major change during the year as its assets have completely changed, and although its business activities have remained similar on balance there has been a major change so it will need to rely on a carve-out to use the losses. Section IB 3(5)(b) allows a major change which is made to keep up to date with technology. As GCG has changed its assets to keep up with advances in technology it will be able to use the carve out in subsection (5)(b).

In the next year GCG discovers an even newer technology that utilises the cat's tail as an antenna to broadcast the signal from the microchip to a central point to enable faster identification of the cats. GCG's assets completely change again to produce the new microchip and receivers. Again, GCG has had a major change due to the change in the assets of the company being such a big part of the business, however, again GCG has made those changes to keep up with technology the underlying business of the company has not really changed. GCG will be able to rely on the technology carve-out to utilise its carry forward losses.

The third carve-out covers increases in scale, including a company entering a different market for its products or services.

The fourth and final category of carve-out covers changes in product or service type. Overall, this carve-out permits:

- a company to pivot and drop a type of product or service and start producing or supplying another that has a close connection (for example, a restaurant operator switching to a cooking school), and
- a company to be able to retain its existing product/service type but also add to it as opportunities arise, as long as there is a close connection (for example, a clothing manufacturer starting a range of commercial cleaning cloths using offcuts from the clothing).

Any new types of product or services need to relate to those already being produced in some way. This might be because they are made using mainly the same assets or processes, or there is some other close connection between those already being produced.

**Example 11**

For the Heart Flour Co. Limited (HFC) has developed a revolutionary technique for adding high levels of quality protein into flour. This creates flour which is superior for bread making. HFC has been producing and suppling this flour to artisan bread makers for several years. Despite its rising business HFC has made losses over the last few years.

Always on my Mind Foodstuffs Limited acquires 100% of HFC and continues its flour business. Three years in HFC discovers that their method of adding protein would have application in sport protein powders.

***HFC starts producing the protein powder and stops producing the flour***

This results in enough of a change in activities and assets to breach the major change test. Always on my Mind Foodstuffs Limited wants to know if a carve-out under section IB 3(5) will apply to allow HFC to carry forward its losses.

Proposed section IB 3(5)(d) allows HFC to change the types of products produced if that involves the company using the same or similar assets or the product is closely related to a product that was provided immediately before the start of the continuity period. The protein powder uses the same IP surrounding the special technique that HFC developed and the old and the new product have a close connection in that they centre around the use of the IP to fortify something with high quality protein. This situation should pass. Likewise, if HFC decided to produce flour and the protein powder the situation should pass under (5)(d). HFC is using its existing resources to expand its product offering.

***The market for the protein powder shrinks and HFC sees an opportunity to simply sell up its assets and get into cryptocurrency mining – a new craze that the small group of shareholders have latched onto as the next big thing***

When compared to the time immediately before the breach in ownership until the time the loss has been used there has been a major change. In dropping the flour and eventually the protein powder, HFC sold off all its assets and acquired computers to mine for cryptocurrency. The product it is not related to any aspect of the HFC business before the change in ownership and it does not use any of the same assets. Even though HFC can cease to make its original product and retain the losses from the earlier enterprise, the rules do not permit it to make anything that it wants following an ownership change and still access those losses. There needs to be a clear connection between the replacement product and the original product. The carve-out for technology will not apply either because this is only intended to cover situations where different technology is used within the continued business, not where a business sees an opportunity in a new technology-based industry.

Proposed section IB 3(7) provides that land (excluding fixtures to land) would be excluded from consideration when a company is looking at whether it can rely on the change in product/service carve-out. This is because land is a big enough asset to skew the way the carve-out is intended to apply.

**Example 12**

Nikki owns and operates All I Needed Was the Rain Limited (ANR), a deer farm in the Wairarapa. Venison prices have been falling lately and ANR is carrying forward losses from the last three years.

In 2023, Nikki sells ANR to David breaching ownership continuity.

David takes stock of his new acquisition. The assets are the land, the fencing set up around large flat paddocks, an irrigation system, water troughs, and several storage sheds for farm equipment, plus 300 head of deer.

David spends the rest of the 2023–24 year farming the herd of deer but not replacing any. In the 2024–25 year he sends off the last of the deer and buys sheep to start producing wool. At this point ANR has experienced a major change, the deer have been switched out for sheep, the product type has changed from meat to wool, the customer has changed, and some suppliers have changed. His assets have changed somewhat but not totally. ANR has also had to do-up an old shearing shed situated on the land at a cost of $100,000. He also spends $150,000 on a flock of sheep.

However, David is able to apply the subsection (5)(d) carve-out for change in the type of product. This is because, although he cannot include the land in his assessment, he uses mainly the same assets in the production of wool as he did for the venison. He leaves the fences, the troughs, and the irrigation system intact. The storage sheds still house farm equipment. All up, $1 million worth of non-land assets are still being used, while $250,000 worth of new assets have been added (including the shearing shed).

In the 2025–26 year, David decides that dairy farming is the future. He sells the sheep and converts the farm. David must look at the business activities at the time he acquired ANR and compare them to the business as it is presently. ANR has experienced a major change in the nature of its business because of the switch from being a venison farm to a dairy producer selling within a cooperative. David again looks to the carve-out for product type. However, in this case the carve-out would not apply as he is not using mainly the same assets anymore. David cannot consider the land value when coming to this conclusion, but he can include other assets. The dairy conversion required a $1.5 million automated milking shed to be installed and the fencing to be replaced to create smaller paddocks centred around a new race system that the cows would use to get to the milking shed. The fencing and raceway cost $200,000 to complete. $400,000 is spent acquiring a herd of cows.

ANR did use much of the same farm equipment and continued to use the storage sheds to keep it. However, these remaining assets only have a value of $500,000 combined. The shearing shed is no longer used. ANR will forfeit any losses carried forward after the change in ownership that were not used prior to the 2025–26 year.

*Measurement period for core test*

The core test must be met for the duration of the business continuity period in order for a tax loss component[3] included in a loss balance of a company to be carried forward. Proposed section IB 4 defines "business continuity period".

For most companies, the business continuity period requires there to be no major change from the time immediately before the breaching change in ownership up until the end of the fifth income year following the change in ownership. As the point of comparison remains the time immediately before the ownership change against the time an amount of the tax loss component is to be used, gradual change can amount to a major change over time.

The five-year period is a maximum length of time that the major change test will have to be considered for most companies. When a tax loss component has been used by a company it no longer exists to be carried forward to a future year. The test therefore only ever considers whether a company can continue to carry forward existing tax loss components and has no bearing on the validity of losses already used. If all pre-ownership breach losses are used within the five years, the company will no longer have to consider the business continuity test as there are no existing tax loss components to which it would apply.

Part year loss provisions in section IP of the Income Tax Act 2007 will continue to apply.

Limiting the business continuity period is intended to reduce compliance and administrative costs while also ensuring that a business is not unduly constrained from making major changes indefinitely as this would impede innovation. It is costly to run a company as a

[3] Tax loss component is defined in section IA 2(7) of the Income Tax Act 2007 as an amount included in a tax loss for the tax year (a net loss for the year and any additional amounts for the year). Section IA 5 provides that a tax loss component carried forward includes any *unused* tax loss component from an earlier year.

genuine business for five years simply to access its losses. This makes loss trading less of a concern at the end of the continuity period.

**Example 13**

All Shook Up House Repilers Limited (All Shook Up) is a company that specialises in repiling and levelling older houses. They have been doing very well over the last number of years due to increased work from various earthquakes around the country.

Bartholomew, the owner of All Shook Up has been looking for new ways to expand his successful business and sees an opportunity in acquiring a comparable business. Steamroller Blues Contracting Limited (Steamroller Blues) is a company that undertakes land works for domestic customers. It has not been doing very well in recent years as Talia, the owner of the company, has not been pricing jobs well. As a result, Steamroller Blues has carried forward tax losses of $5 million.

Bartholomew purchases 100% of Steamroller Blues on 1 June 2021 and keeps the business operating but focuses on pricing the jobs more appropriately. In addition, the acquisition increases the customer base of the company. It is clear that Steamroller Blues has not had a major change during the business continuity period.

At the end of the company's 2026–27 income year (31 March) Steamroller Blues has $600,000 of the original tax losses still available. In the 2027–28 income year Bartholomew sees an opportunity in school classroom construction and wants to make some changes to the company by selling all of its assets and replacing these with heavy machinery to erect buildings.

As Steamroller Blues is outside the five-year business continuity period the major change requirements will no longer need to be satisfied and therefore there are no tax restrictions on Steamroller Blues making changes to its business. The company will continue to be able to access the remaining losses.

However, if instead Steamroller Blues uses $4 million of its carried forward losses but has a major change at the end of the 2025–26 income year, it would forfeit the $1 million of unused losses.

The five-year business continuity period would not apply to all companies. For companies carrying forward losses consisting of significant deductions for bad debts claimed under section DB 31(3) of the Income Tax Act 2007 proposed section IB 4(1)(a) provides that the business continuity period will remain until the losses carried forward are utilised.

This condition is proposed to address concerns that a failed finance type company could be an attractive loss trading proposition. Failed finance companies may too easily satisfy the business continuity test even when they should not. A failed finance company may be acquired and, although the company is largely inactive, satisfy the test because the financial arrangement assets remain, and its activities are continued at a minimal level for five years to satisfy the business continuity test period. After five years the acquiror would be free to inject income into that company in order to use up the losses, for example, by transferring a profitable restaurant business into what was the finance company.

Losses arising as a result of bad debt deductions are the primary concern. Bad debt deductions arise when a taxpayer is in the business of "holding or dealing" financial arrangements and that taxpayer writes off a debt as unrecoverable. These are the types of deductions that can result in the large losses failed finance companies carry forward. By applying the business continuity test until the pre-breach losses have been used the losses acquired are restricted for use within the business that generated them, and Inland Revenue will be able to apply anti-avoidance rules to any loss trading type activity.

Proposed subsection IB 4(2) contains the formula to be used when calculating whether proposed subsection IB 4(1)(a) would apply, subsection IB 4(3) defines the items in the formula. In short, the calculation requires that all deductions in years a company records a loss that is included in its loss carry forward balance immediately before the breach in ownership continuity starting from the 2013–14 income year to be totalled. This total deduction amount is compared to the amount of section DB 31(3) deductions taken in those loss years. Any income derived under section CG 3 as a result of the recovery of DB 31(3) bad debts should be subtracted from the total deductions and from the DB 31(3) deductions claimed in those years. If the formula results in 50 percent or more of the loss carried forward being attributed to DB 31(3) deductions then the business continuity test applies until the losses are used.

**Example 14**

Always on my Mind Finance Limited (AMF) is a company that is in the business of holding or dealing in financial arrangements. It has incurred some losses relating to bad debt deductions under section DB 31(3) which relate to the amounts owing under financial arrangements.

It has incurred these losses over four years as follows:

| Year | Income | Deductions (other than DB 31(3)) | DB 31(3) deductions/ (recoveries) | Net taxable income/(loss) |
|---|---|---|---|---|
| 2016–17 | 5,000,000 | 1,500,000 | 6,000,000 | (2,500,000) |
| 2017–18 | 2,000,000 | 3,000,000 | 7,500,000 | (8,500,000) |
| 2018–19 | 1,500,000 | 600,000 | 600,000 | 300,000 |
| 2019–20 | 1,000,000 | 2,000,000 | (200,000) | (800,000) |
| Total | 9,500,000 | 7,100,000 | 13,900,000 | (11,500,000) |

Way Down Mortgages Limited (Way Down) is a mortgage lending company which is looking toward expansion and although AMF has not been performing well, Way Down thinks that with the right management this business can be turned around as the remaining portfolio of the company is promising.

AMF wants to understand how the new business continuity rules will apply to the tax losses carried forward by Way Down. It asks Lloyd the company's accountant for some advice. Lloyd has a look at section IB 4 and also the tax returns for Way Down.

| Year | Deductions (other than DB 31(3)) | DB 31(3) deductions/ (recoveries) | Total deductions |
|---|---|---|---|
| 2016–17 | 1,500,000 | 6,000,000 | 7,500,000 |
| 2017–18 | 3,000,000 | 7,500,000 | 10,500,000 |
| 2019–20 | 2,000,000 | (200,000) | 1,800,000 |
| Total | 6,500,000 | 13,300,000 | 19,800,000 |

Lloyd advises that, because in the years that Way Down has made losses the ratio of DB 31(3) deductions to the total deductions is 67.2% ((13,300,000 ÷ 19,800,000) × 100), Way Down can carry forward its losses but the five-year rule will not apply to them. They will need to meet the requirements of the business continuity test until the losses are utilised.

*Application to corporate groups*

Currently, a company may offset its losses against other companies' profits if it meets continuity of ownership requirements and has at least 66% common ownership with the companies when the loss is incurred. The loss will be made available to from the time the loss arose until the time it is used.[4]

[4] Subpart IC of the Income Tax Act 2007.

The proposal leaves the commonality requirements unchanged. Companies in the original group that are acquired together would meet the group test (for example, they were 100% commonly owned when the loss was made and remain 100% commonly owned when the loss is to be offset). The acquired group will also form a new group with the acquiring company/group, however, because the commonality rules would fail to allow loss offsetting within the "new" group the pre-acquisition losses cannot be offset with other companies in that "new" group.

For the continuity requirements the proposal is that companies which meet commonality requirements immediately before and immediately after acquisition would be treated as a single company for the purposes of applying the business continuity test to carry forward pre-acquisition losses under proposed section IB 5. When assessing if there has been a major change the acquired group must be looked at as if it was a single company rather than separate entities.

Consequential amendments are proposed to the consolidation and amalgamation rules to incorporate the business continuity test but no changes are proposed to how these regimes operate.

**Example 15**

The Fame and Fortune Casino Group (FFG) is a group of companies operating a casino business. This Group is made up of a holding company and a number of subsidiaries which, as a whole, operate the casino business, one of these subsidiaries provides the finance function of the group. The finance subsidiary is carrying forward a loss.

FFG is acquired by the Money Honey Casino Group (MHG), another casino operating group of companies. MHG has a finance company and, because it is inefficient to keep two finance companies, FFG's subsidiary finance function is wound down after the acquisition.

When MHG acquired FFG ownership continuity was breached. When applying the business continuity test to determine whether the losses of the FFG can be carried forward after the change in ownership the business activities of the whole group must be considered. When considered as a single company the Group carries on the same income generating business activities it did before being the casino. It also uses the same income generating assets to do so. On these facts FFG should be able to carry forward any pre-acquisition losses its members might have, and those losses will remain available to offset income within the FFG but not within the new group formed with the MHG because the commonality requirements are not met for those losses.

### *Anti-avoidance*

A number of proposals have been developed to support the core test and ensure it does not open up opportunities for loss trading. The key purpose of the loss continuity rules remains to prevent this activity.

*Dormant company rule*

Proposed section IB 3(3)(a) would disallow the carry forward of losses if the change in ownership occurs at any time after the business activities of the company have ceased and before any revival of the business. The proposed rule does not require assessment of whether a company is completely dormant, but it should deal with companies that are no longer viable and really only have value in their stock of tax losses. Similarly, proposed section IB 3(2)(b) would disallow any further carry forward of losses where a company ceases to carry on any business activities (in effect becomes dormant after the change in ownership).

The dormant company rule does not apply to a temporary reduction in activity. A company may be seasonal or may have to temporarily suspend trading due to Government order but as long as the income earning infrastructure remains ready to be operational there is no cessation of the business that will trigger the dormant company rule. Likewise, the proposal does not consider low activity industries to trigger the rule. It does not matter that a company is being run by receivers or liquidators as long as there remains a sufficient level of business activity.

**Example 16**

Golden Coins Ltd operates claw game machines to thirty shopping centres. It installs the machines and staff regularly visit the sites where they are installed to collect any money and replenish the supply of novelty stuffed animals.

Buying and installing the machines was an expensive exercise, it also proves expensive to service and stock the machines. Golden Coins incurs significant losses over the two-year period it operates.

The machines are poor quality and the claws constantly break. The number of players dwindles as the machines become known as unreliable and stingy with their prizes. Golden Coins decides not to stock or service the machines anymore and leaves them to slowly empty out. The shopping centres ask for them to be removed and they are all taken back to a warehouse that Golden Coins is leasing. After a month, the sole shareholder Jim, sells the business to his friend Rob. The machines are defunct and all that is left is the idea that maybe they could be refurbished and a lease for the warehouse where they are stored. There is otherwise no other activity happening.

The policy intent is for the dormant company rule to apply in this situation to not allow the carry forward of losses as at the time of the change in ownership the business activities carried on by Golden Coins had ceased.

*Change in business activities prior to acquisition*

Proposed section GB 3BA is a specific anti-avoidance rule to prevent arrangements that are made between the purchaser and seller of a company prior to a transaction that are intended to defeat the business continuity test or the dormant company rule. If taxpayers are able to avoid the intended application of the test, then avenues for loss trading schemes could arise.

**Example 17: Change in assets**

Milkcow Blues Boogie Cheese Limited (MBBC) is a poorly managed manufacturer of cheese with significant tax losses to carry forward. The cheese MBBC is known to produce has a terrible reputation and the shareholders have decided to sell the company rather than fix it. Spinout Limited (Spinout), a manufacturer of very good pulled toffee, hears the shareholders of MBBC are looking to sell and that the company has significant losses. The assets MBBC currently has are not very useful for toffee, but the staff can probably be retrained. Spinout knows that replacing the assets of MBBC after the change in ownership is going to breach the major change test and arranges for MBBC to dispose of speciality cheese equipment and to acquire toffee machines before the sale of shares takes place.

Section GB 3BA would apply to this situation to prevent MBBC from carrying forward its pre-acquisition losses because in the two years prior to the ownership continuity breach MBBC and Spinout entered into a verbal arrangement where the sale of shares of MBBC was made conditional on the assets being changed so that the business of Spinout could be carried out after the ownership change without breaching the core business continuity test.

**Example 18: Change to a dormant company**

A Little Less Conversation Limited (ALLC) was a publishing company that put out a popular political magazine. However, the operations were mothballed when the chief editor quit and the content became less popular. ALLC sustained substantial losses. After three years, Judy, a shareholder with a 10 percent stake in ALLC had an idea to start a high fashion magazine. They approached the other shareholders in ALLC offering to purchase the remaining 90 percent of the shares if ALLC's business was restarted and produced the magazines as requested by Judy for six months. ALLC began to produce the magazines. Six months later, as agreed, the remaining 90 percent of shares in ALLC were transferred to Judy who continued on with the fashion magazine.

Section GB 3BA would apply to this situation to prevent the dormant company rule being circumvented by an arrangement to restart a business before the change in ownership.

*Anti-injection rules*

One way to engage in loss trading activity is to buy a loss company and inject some profitable activity or reduce its costs to soak up available losses. An acquirer may purchase a company and continue to run its business activities while also injecting amounts of income into the business or transferring costs out of the business that are small enough not to be regarded a major change. This is most likely to occur with an associated person. Proposed sections GB 3BAB and GB 3BAC are specific anti-avoidance rules and would only apply where a company is relying on the business continuity test to carry forward losses. The rules would not apply to companies more broadly.

The anti-injection rules would apply if all of the following conditions are met:

- The company is party to an arrangement.
- The effect of the arrangement is that the company derives assessable income or is allowed a deduction for an amount of expenditure or loss that, but for the arrangement, an associated person would have derived or incurred, would in all likelihood have derived or incurred, or might have been expected to derive or incur.
- The sole or main purpose of the arrangement is tax avoidance.

It would not apply where, for example, employment contracts are shifted to a group member and there is a recharge to the loss company or where efficiencies are made by using other group employees to now provide services to the acquired company rather than, say, use consultants that were previously providing the services (for example, a loss company uses a firm as tax advisors but the acquirer has a tax division who would now undertake that task).

In the case of income injection, section GB 3BAB applies to deem the amount of injected income to be schedular income of the loss company. This results in tax to pay on that income (plus any associated shortfall penalties). In the case of cost shifting, section GB 3BAC applies to disallow the deduction for expenditure or loss in the profit company resulting in tax to pay on the income it offset (plus any associated shortfall penalties). The loss company is then treated as having incurred the amount of expenditure or loss.

**Example 19**

Moody Blue Boat Ltd (Moody Blue) is a failing manufacturer of fish finding equipment for boats. It has sustained significant losses over the last five years due to mismanagement. It's Midnight Music Ltd (Midnight) buys and licences songs for use in events. It is a profitable business with no tax losses available to offset any income it derives.

In August 2020, Midnight acquires Moody Blue and carries on manufacturing the standard fish finding equipment it is known for and ensures the business is properly managed. There is no major change in the activities or assets of Moody Blue and so it is able to carry forward its losses relying on the business continuity test.

Midnight also sees an opportunity to assign some of its income to Moody Blue Co in order to take advantage of the available losses and reduce overall tax paid on the business of Midnight. In November 2020, an arrangement between Moody Blue and Midnight is entered into whereby some of Midnight's licences are assigned to Moody Blue. This becomes a very small part of Moody Blue's business and does not reach the threshold of major change.

However, the section GB 3BAB anti-injection rule applies to prevent the injected income from being offset with any remaining losses in that year. This applied because Moody Blue had a tax loss component it was carrying forward in reliance of the business continuity test, and but for the arrangement Midnight would have derived the income from the licencing activity, and the income was injected with the sole purpose of tax avoidance – Midnight entered the arrangement to reduce tax on its own business activities.

**Example 20**

Patch It Up Paint Ltd (Patch It Up) does painting and decorating for domestic clients. In recent years it has run into difficulty – it is poorly managed, and staff do not work efficiently or neatly. The client list slowly begins to shrink and Patch It Up suffers significant losses from 2016–2019. Patch It Up has found itself on the edge of failure and Barbara, the owner of the business, starts looking for a buyer.

Di owns and operates Rip It Up Decorators Ltd (Rip it Up). Rip It Up also does painting and decorating for domestic clients and has been very successful. In the 2020 year, Di secures the ownership interests in Patch It Up for a bargain price. This breaches ownership continuity but Di relies on the business continuity test to carry Patch It Up's losses forward. Di thinks there is an opportunity to unlock the value of the losses by moving some costs to Rip It Up.

It seems logical to Di for Rip It Up to secure all the paint for both companies. A deduction for the paint arises in Rip It Up, Patch It Up no longer incurs this cost. In addition, Patch It Up has a loan with a bank that is resulting in deductions for interest payments. Di arranges for Rip It Up to pay the loan back on behalf of Patch It Up, but funds this repayment with a loan from another bank. Deductions for interest payments now arise in Rip It Up. The combination of these two arrangements results in Patch It Up returning to profit and therefore using its losses.

Rip It Up wants to use the deductions for interest payments and paint acquisition to reduce its own tax. However, Rip It Up's accountant notes that section GB 3BAC applies to disallow these deductions. This is because there has been an arrangement between related parties which resulted in deductions that would have been incurred by Patch It Up being incurred by Rip It Up. Tax avoidance was the main purpose because Di entered these arrangements in order to access the losses of Patch It Up. GB 3BAC applies to treat Patch It Up as having incurred the expenditure that gave rise to the deductions. Rip It Up is reassessed and has tax to pay once the deductions have been taken away, shortfall penalties are also imposed.

### *Previously forfeited losses*

Proposed sections IB 3(3)(b) and (c) are incorporated to confirm a taxpayer cannot revive a tax loss component:

- that has previously been subject to a change in ownership followed by a major change, or
- that was subject to a change in ownership before the 2020–21 income year.

### *Consequential amendments*

Other proposals are consequential amendments to sections of the Income Tax Act 2007 which reference the loss continuity rules to ensure that, where appropriate, reference is made to the proposed business continuity test. These include amendments to rules relating to the carry forward of certain tax credits which are intended to mirror the rules for the carry forward of losses. These are research and development tax incentive credits, attributable controlled foreign company income tax credits, and tax credits for supplementary dividends.