

Supplementary Analysis Report: Loosening the loss continuity rules

Section 1: General information

Purpose

Inland Revenue is solely responsible for the analysis and advice set out in this Supplementary Analysis Report (SAR), except as otherwise explicitly indicated.

This SAR explains the policy rationale and development behind the proposal to loosen the loss continuity rules to be included in the *Taxation (Annual Rates for 2020-21 Feasibility Expenditure and Remedial Matters) Bill*. It has been produced to improve transparency and understanding of the policy as the amendments go through the legislative process.

Making changes to the loss continuity rules was recommended by the Tax Working Group in its final report, *“Future of Tax”*.¹ As a result the project has been on the tax policy work programme since 2019. In September 2019, the Government announced it would consult on options to loosen the loss continuity rules in order to promote growth and innovation of start-ups and small-medium enterprises as a productivity enhancing policy.

A discussion document – *Tax Losses: loss continuity and R&D related provisions* – was approved for public release by the Government on 18 March 2020. However, on 15 April 2020, the Government announced that it would accelerate this work in response to the economic impacts of COVID-19 and introduce a business continuity test after consulting on the detailed design, with retrospective application from the 2020-21 income year.

The discussion document functioned as an interim RIA when it was considered by Cabinet and a final RIA was not prepared due to the short timeframe for developing policy in response to COVID-19.

Key Limitations or Constraints on Analysis

The announcement on 15 April 2020 that the Government would introduce a business continuity test modelled on Australia’s rules with retrospective application to the 2020-21 year is a limitation on the analysis.

Taxpayers who raise capital during the COVID-19 economic downturn have been able to take comfort from the proposed introduction of a test that would assess the continuation of their underlying business and that would leave them no worse off than the full Australian test. This limited any further analysis on the other options and focused policy development on how to adapt the Australian business continuity test for the New Zealand context.

¹ Tax Working Group (2019) *Future of Tax*. Retrieved from: <https://taxworkinggroup.govt.nz/resources/future-tax-final-report-vol-i>

In order to enact new loss continuity rules by the end of the 2020-21 year the proposal needs to be included in the *Taxation (Annual Rates for 2020-21 Feasibility Expenditure and Remedial Matters) Bill*. This materially limited the time available for developing the policy and the draft legislation. Due to the short timeframe for development, officials only carried out targeted consultation. The policy has not been tested with the broader public.

Responsible Manager (signature and date):

Bary Hollow
Principal Advisor
Policy and Strategy
Inland Revenue

11 February 2021

Quality Assurance Reviewing Agency:

Inland Revenue

Quality Assurance Assessment:

The Quality Assurance reviewer at Inland Revenue has reviewed the Loosening the loss continuity rules SAR and considers that the information and analysis summarised in it **meets** the quality criteria of the Regulatory Impact Analysis framework.

The Key Limitations or Constraints on Analysis section of the SAR notes that analysis and consultation on options was limited after the Government announced it would implement a business continuity test in April 2020. While this may have limited analysis on options that were not preferred, consultation back to the Tax Working Group has identified the issues with a business continuity test and the analysis of the costs and benefits of the preferred option is well explained. The reviewer considers that the information in the SAR is as complete as could be expected and identifies the main risks and uncertainties.

Reviewer Comments and Recommendations:

Comments from the review of earlier versions of this SAR have been incorporated into this version.

Section 2: Problem definition and objectives

2.1 What is the policy problem or opportunity?

Losses and income are treated asymmetrically under New Zealand's company tax system. Companies pay tax when their income is positive, but the Government does not provide a refund when income is negative. Refunding losses would be the most efficient way to recognise losses. However, no country in the world does this because it is fiscally expensive and raises integrity concerns around the artificial generation of losses to obtain refunds. Instead losses can be carried forward to offset future income of the company or other group income. Recognising tax losses in the system means that most taxpayers pay an appropriate amount of tax over their lifetime.

The loss continuity rules in the Income Tax Act 2007 set out the extent to which companies can carry forward tax losses to offset future profits when there is a change of ownership of the company. For losses to be carried forward at least 49% continuity of ownership of the company is required to be maintained from when the loss arose until the time it is used. New Zealand's rules are among the most stringent in the world and mean companies capital raising will forfeit losses if, in doing so, they have a change in ownership of more than 51%.

The purpose of these rules is to prevent loss trading. Loss trading is where there is little or no economic basis for a transaction in which a company acquires another company; the acquisition is made purely to access the tax losses to offset against its income. Loss trading presents a major risk to the revenue base. Where loss trading allows companies to avoid paying tax it undermines the integrity of the tax system and erodes social capital. Existing stocks of losses are very large, around \$44 billion.

The 49% threshold limits any incentives to engage in loss trading because any income injected into that company to use up losses will also benefit the 49% of shareholders that have not changed. The threshold is a proxy for control, a change by more than 51% of the voting power in theory means that control of the company has changed.

The specific policy problem is that the focus on preventing loss-trading creates an impediment for companies obtaining capital in order to innovate and grow because capital raising can result in a breach of the 49% ownership continuity threshold. The impediment can lower the amount of capital an investor is willing to put into a company and that an existing owner is willing to accept. This is because any existing losses will have no value if there is a change in ownership and the company will have to pay tax on profits sooner as a result. In some extreme cases the rules can even prevent a transaction from happening at all. As much as possible, the tax system should not get in the way of sensible business transactions. Based on data collected by Inland Revenue from company tax returns, it is estimated that on average the tax value of losses forfeited by companies as a result of changes in ownership is \$60 million a year.

The current settings prevent loss trading but arguably impede transactions which have nothing to do with the availability of a tax loss. The problem is particularly acute for start-ups as these businesses often have multiple capitalisation rounds as the business grows from an idea to a viable business. However, it is also recognised that companies seeking to recover from the impacts of COVID-19 have been undertaking capital raising in order to remain resilient (among other reasons).

2.2 Who is affected and how?

Currently, tax is acting as a barrier to sensible business decisions that companies can make to restructure their ownership and to bring in new investors. The evidence for this is anecdotally provided by stakeholders and has been included in submissions to Ministers and the Tax Working Group.²

2.3 What are the objectives sought in relation to the identified problem?

The objectives sought are to lessen the impact of the tax system on investment decisions in order to promote growth and productivity, particularly for start-ups and small-medium enterprises while still preventing loss trading opportunities.

² For example, the BusinessNZ submission to the Tax Working Group included a number of real examples where the loss continuity rules have been an impediment to capital raising. Accessed at: <https://taxworkinggroup.govt.nz/sites/default/files/2018-09/twg-subm-3983184-businessnz-6-of-6.pdf>

Section 3: Options identification

3.1 What options have been considered?

- Option 1 – Status quo
- Option 2 – Business continuity test
- Option 3 – Lower the ownership continuity threshold
- Option 4 – Introduce a formula for loss carry forward

Options 2-4 are all legislative tests which aim to loosen the loss continuity rules while still preventing loss trading.

All options were assessed against four criteria:

- *Fairness*: the options should improve horizontal equity so that different taxpayers with similar levels of income pay similar levels of tax.
- *Efficiency*: the options should lessen the impact of the tax system on economic behaviour.
- *Complexity*: the options should reduce complexity as much as possible.
- *Tax system integrity*: the primary function of a tax system is to provide revenue to fund government spending priorities. The options should maintain protection against loss trading which can reduce revenue and reduce social capital.

Option 1 – Status quo

This option is to retain only the current ownership continuity test. Companies would continue to forfeit tax losses if, through capital raising or other reorganisation, there is more than a 51% change of ownership.

Evaluation against criteria

Fairness: Taxpayers that have a 51% or more change in ownership while carrying losses forward have a higher effective tax rate over the same period of time compared with a company in a similar position but without a change in ownership which impacts on fairness between taxpayers.

Efficiency: The status quo would continue to impede capital raising and other sensible business reorganisations when these activities result in the forfeiture of losses.

Complexity: The current system is relatively simple in operation. Taxpayers and Inland Revenue, as the administrators, are familiar with the rules. However, some complexity can arise where taxpayers seek to avoid the forfeiture of tax losses due to an ownership continuity breach.

Tax system integrity: The current rules prevent loss trading which is their primary purpose. The status quo would maintain the robustness of the tax system in this area.

Option 2 – Business continuity test

This option allows losses to be carried forward after a change in ownership as long as the underlying business is fundamentally continued. Rules for New Zealand would be modelled on Australia's test with some modification to ensure they are flexible enough to permit the types of ownership changes businesses naturally make in order to maximise their profits.

Evaluation against criteria

Fairness: Overall, this option should increase fairness. For companies that meet the business continuity test the effective tax rate will be the same over its lifetime as a company in a similar situation but that does not have a change in ownership. However, the option would not improve fairness for all companies. For some, particularly at the margin, difficult fact situations will mean that the business continuity test will not apply to carry forward losses and the effective tax rate over time will continue to be higher than a company without a change in ownership. This will occur because it is difficult to design a subjective test that will apply to every situation while ensuring that loss trading opportunities are not created.

Efficiency: Overall, this option should increase efficiency because it allows a company to have changes in ownership without necessarily having to forfeit tax losses. However, the option also needs to build in flexibility for the company to make changes to its business that it could have done absent the change in ownership. It would be undesirable from an efficiency perspective for tax to limit the ways in which a company can develop and grow its business. A flexibly designed business continuity test can accommodate capital injections and allow the carry forward and use of losses that would have been forfeited due to the ownership continuity breach.

Complexity: There is potential for complexity arising due to the subjective nature of the test. Its application requires consideration of specific facts and circumstances. The test can be designed so that for most taxpayers its application to their situation is straightforward. This is achieved by making the test only as strict as it needs to be to prevent loss trading and ensuring that typical changes a business makes to its operations are well catered for. However, for some taxpayers the test will be challenging to apply to their unique facts and could require costly legal advice, which may include seeking taxpayer rulings from Inland Revenue.

Tax system integrity: The test limits the use of losses to the business that generated them. This protects against loss trading and ensures that other taxpayers are not able to use the losses to reduce their own taxable income from another business. Additional safeguards would be needed to ensure that facts are not manipulated in order to meet the business continuity test and engage in loss trading. This increases the complexity of the option compared to the status quo.

Option 3 – Lower the ownership continuity threshold

This option is to lower the current ownership continuity requirement from 49% to a threshold that reduces the number of transactions that would result in a breach.

Evaluation against criteria

Fairness: Lowering the threshold would continue to apply restrictions on transactions that breach that new threshold. In particular, transactions where all of the shares of the company are purchased would continue to result in the forfeiture of losses. While lowering the threshold increases fairness for companies that are able to carry forward losses that would have been forfeited under the status quo some companies will continue to experience breaches. Companies in this category would pay more tax over time compared to a company with a similar level of income that does not breach the new threshold.

Efficiency: The main benefit would be to allow increased new equity investment into a company before the ownership continuity rules are triggered and losses are forfeited. Capital raising may result in a majority change in shareholding that would otherwise breach continuity under the status quo. At the point of the new threshold the option would continue to limit sensible business reorganisations, for example 100% takeovers where there is less likely to be a loss trading motivation. Sometimes the strategy is to build up a business with a view to making it appealing for takeover by a larger company. This sort of activity can be beneficial to the New Zealand economy as often takeovers are necessary in order for a business to access global markets. It may be that being acquired by a larger company is preferred from an efficiency perspective. Lowering the threshold would not benefit such transactions. The problem with the status quo is not solved, only shifted.

Complexity: This option has the advantage of being simple to implement and, in theory, could be done relatively quickly. Some complexity could arise ensuring that there remains sufficient protection against loss trading.

Tax system integrity: Some preliminary modelling by officials demonstrated that the lower the threshold the easier it is to enter arrangements that create loss trading opportunities. Other supporting measures would be needed which would erode the simplicity of the option.

Option 4 – Formula for loss carry forward

Under this option losses could be carried forward after a breach in ownership continuity, but the amount of losses that could be used would be restricted by a formula related to the value of the company at the time of the continuity breach. The formula would be designed to approximate the value of the losses to the company had there not been a change in ownership. The formula would either be the value of the company:

- multiplied by some number to determine the stock of losses that can be carried forward; or
- multiplied by an interest rate to determine the amount of losses that can be used each year.

Evaluation against criteria

Fairness: This option would increase fairness to the extent it achieves its objective of preserving the value of a loss for more companies after a change in ownership. This is because the option should, in theory, provide most companies with the same ability to use their tax losses before and after the change in ownership. However, a formula does not accommodate increases in value from capital injections made to commercialise and

expand the business (i.e., make it more valuable). Companies that are made more valuable because of the change in ownership will not have this factored into the amount or rate of losses available after a change in ownership. There are also challenges around setting the rate to multiply the company value by. It is unlikely that there is a single rate which can maintain the value of losses in all situations and trade-offs have to be made between fairness and ensuring that opportunities for loss trading are not created.

Efficiency: If a formula can closely approximate the value of losses in the absence of the continuity breach, it will improve efficiency. In theory, it should permit a company to seek new investment without considering the impact on its losses. However, a significant limitation of a formula is that it limits the use of losses based on the value of the company at the time ownership changes. As noted above, this does not accommodate increases in value from capital injections. This could be particularly problematic for high-growth start-ups that rapidly expand with capital injections. For this reason, and because of the difficulty setting a multiplier rate, a formula may continue to cause an impediment to capital raising activity by constraining the use of losses.

Complexity: It may be very difficult to design a formula which does maintain the value of losses for most companies after a change in ownership. This is due to the complexity surrounding the values to use in the formula. To work, a formula needs a company value and a rate to apply to that value in order to set the amount or rate of losses that can be used. The valuation of companies is a complex area. For public companies this information is readily available but for private companies it can be significantly more complex to determine. This option may result in large compliance costs for companies changing ownership that have to determine a specific value for use in the formula. While there are at least two other countries that take a formulaic approach (the United States and Sweden) public commentary on these tests almost universally agree they introduce significant complexity. The option did not get stakeholder support, primarily because of how complex it would need to be to work as intended.

Tax system integrity: A formula should maintain the integrity of the tax system. The theory behind a formula is that it should result in a situation where it never makes sense to pay for a tax loss alone. However, supporting rules would be required to ensure that the value of the company is not artificially inflated to increase the value of the losses the formula will permit to be used following the change in ownership.

3.2 Which of these options is the proposed approach?

The proposed approach is option 2, the business continuity test modelled on Australia's rules. Officials consider that is the best option on balance. Previously, officials have advised the Government that if it wanted to progress an option quickly as a COVID-19 response, the business continuity test would be the preferred option to develop on an accelerated timeline.

COVID-19 has shown that companies are able to pivot quickly into producing something else in response to external pressures. The proposed business continuity test can be designed so that the types of changes to the direction of a business that would have happened without the ownership change would be permitted and only the changes that mean losses become available to shelter the income of another taxpayer with no real interest in carrying on the business would be disallowed. The test will prevent loss trading by requiring the business itself to be continued.

A business continuity test has the advantage of international precedent having been picked up in some form by approximately 15 OECD member countries. New Zealand is able to look to other countries' success and failure in the design process which can help to minimise complexity.

Overall, the preferred option has significant support from stakeholders and, by drawing on international precedent, officials are confident that a test can be incorporated into the New Zealand system in a way that achieves the policy objectives. The test will allow businesses to reorganise or recapitalise without unduly restricting what they can do after a change in ownership. However, the option necessarily limits, for integrity reasons, the amount of change that can occur. For some companies this means that the business continuity test will result in the forfeiture of losses. This is an appropriate result where the fundamental business of the company has changed because without such a limitation it would be possible to engage in loss trading activity.

Section 4: Impact Analysis (Proposed approach)

4.1 Summary table of costs and benefits

Affected parties (identify)	Comment: nature of cost or benefit (eg, ongoing, one-off), evidence and assumption (eg, compliance rates), risks	Impact \$m present value where appropriate, for monetised impacts; high, medium or low for non-monetised impacts
Additional costs of proposed approach, compared to taking no action		
Regulated parties Companies	The test is subjective so there are interpretation risks that will apply at the margin to reduce the overall benefit. Some companies may not be able to use the rules even though they are not loss trading. Legal advice on specific facts and circumstances may need to be sought. However, the 49% ownership test will remain and can be relied on to carry losses forward. Companies are not required to make use of the business continuity test.	Low
Regulators Inland Revenue	Some administrative costs associated with monitoring companies relying on the business continuity test, updates to website and other standard implementation tasks. This would be met within existing baselines.	Low
Wider government	Losses that would previously have been forfeited can be carried forward to offset profits that the company would have to pay tax on if no action were taken and they were not able to retain losses after an ownership change. This results in a loss of revenue to Government.	Up to \$60 million less revenue collected a year. This figure is the average tax value of all losses that are forfeited in an average year. It is an upper bound to the expected cost under the Australian test, if all forfeited losses were able to be absorbed each year.
Other parties	N/A	N/A

Total Monetised Cost		Up to \$60 million forgone revenue a year.
Non-monetised costs		<i>Low</i>

Expected benefits of proposed approach, compared to taking no action

<i>Regulated parties</i> Companies	<p>Losses that would previously have been forfeit can be carried forward to offset profits that companies would have to pay tax on if no action were taken and they were not able to retain losses after an ownership change.</p> <p>Companies are able to raise capital without losing access to losses and so can seek out opportunities to grow and innovate.</p>	<p>Up to \$60 million a year tax saved for companies</p> <p><i>Medium</i></p>
<i>Regulators</i> Inland Revenue	N/A	N/A
Wider government	N/A	N/A
Other parties	N/A	N/A
Total Monetised Benefit		Up to \$60 million a year
Non-monetised benefits		<i>Medium</i>

4.2 What other impacts is this approach likely to have?

The proposal impacts all corporate taxpayers. However, it only has relevance for company lifetime events that are irregular major transactions and does not have wider implications for companies that are not changing ownership. It does not impact individuals or trusts as continuity rules do not apply to them.

Section 5: Stakeholder views

5.1 What do stakeholders think about the problem and the proposed solution?

Stakeholders have long been advocating for change in this area with submissions on the problem being made to the Tax Working Group and to Ministers directly. In September 2019 the Government announced it would consult on options to loosen the loss continuity rules. Following this, officials engaged with a range of stakeholders as part of an early engagement process ahead of planned formal consultation. This consultation sought preliminary views on the options that should be considered and what the advantages and disadvantages of each might be. During this process most stakeholders expressed a preference for a business continuity test.

However, in order to progress a solution along a quicker timeline in response to COVID-19, the Government agreed that targeted consultation on only the business continuity test should be carried out with key stakeholder groups. The specific stakeholders consulted were the Corporate Taxpayers Group, Chartered Accountants Australia and New Zealand and members of the New Zealand Law Society Tax Law Committee. A small group of stakeholders from both smaller and larger advisory firms was also set up for consultation. These stakeholder groups were chosen as they are representative of those who will use the test and advise on it.

Stakeholders are in agreement with the problem and the proposed approach to resolving it. The feedback has been that they are pleased to see a solution to the problem developed that is closely related to the problem definition. Adaptation of the Australian test to work in a New Zealand context has been done in conjunction with the stakeholder groups.

In particular, the Australian test has been modified in response to stakeholder feedback in order to focus on inputs a company uses in its business rather than outputs. Focusing on what resources a company uses to generate income better focuses on what the underlying business is. Focusing on products does not recognise that companies often seek out new applications for their intellectual property or asset base and that this suggests evolution not loss trading.

The test has also been made more permissive by incorporating the approach taken by the United Kingdom to a business continuity test. This is a modification from the test requiring a company to demonstrate it remains the same/similar to carry the losses forward (Australian approach) to assuming the company can carry losses forward unless it has a major change in its assets or activities. This approach focuses on ownership changes where the underlying business is continued, rather than requiring an assessment of how static the business of a company is.

The key concern remaining for stakeholders is that the test may still prevent some companies from carrying losses forward for which there is no reason to exclude. This is because the business continuity test has boundaries to ensure that changes that are too significant will not pass. Without these boundaries loss trading opportunities could arise but they do create a limitation for genuine commercial changes to the business that sit outside of what the test permits. However, stakeholders generally agree that these should only be at the margin and that the rules can be reviewed following implementation to see how they are working in practice.

Section 6: Implementation and operation

6.1 How will the new arrangements be given effect?

The new rules will be legislated via the *Taxation (Annual Rates 2020-21, Feasibility Expenditure, and Remedial Matters) Bill*, and will apply to changes in ownership which breach the 49% threshold that occur in the 2020-21 or later income years.

In conjunction with the enactment of the legislation, Inland Revenue will publish guidance on the new rules so that taxpayers and advisors are aware of them and have time to prepare. This guidance would also provide taxpayers something to rely on to interpret how the rules apply to them. The current rules for loss carry forward require a taxpayer to self-assess their eligibility. The new business continuity test operates in the same self-assessment model so a long lead-in period is not necessary. Taxpayers are already required to maintain records to support a tax position taken for at least seven years.

Inland Revenue will be responsible for the ongoing operation and enforcement of the proposal. No concern has been expressed about Inland Revenue's ability to do so. Inland Revenue already carries out this function with respect to the existing loss continuity rules. Compliance with the new rules will be monitored through routine compliance activities.

Section 7: Monitoring, evaluation and review

7.1 How will the impact of the new arrangements be monitored?

Officials regularly meet with stakeholder groups and can use these meetings to seek feedback on how the rules are working for taxpayers once they are in force. Feedback from Inland Revenue Customer Compliance Specialists will also be sought in relation to how the rules are working administratively.

Data will be collected on taxpayers that have a change in ownership. This will allow information to be collected on the numbers of companies making use of the new regime. It will also provide information on the value of losses these companies are carrying forward under the business continuity test.

Inland Revenue already collects data on losses carried forward as taxpayers must include this in annual returns. However, this information would not provide insight into how well loosening the loss continuity rules is working to encourage growth and innovation outcomes. It will be easier to measure the ability of the new rules to prevent loss trading. As loss continuity rules exist to prevent this activity it will be considered a successful outcome to observe companies carrying forward losses after a change in ownership without there being evidence of loss trading.

7.2 When and how will the new arrangements be reviewed?

A post-implementation review plan has been agreed between Inland Revenue and the Treasury. If appropriate, a survey of companies relying on the test could be carried out to get additional information.

This review would cover the amount of losses that are still estimated to be lost each year. From 2022 information on the business continuity test will be available to Inland Revenue audit function. This should allow for a risk review and for information on whether there is any loss trading as a result of the policy. Due to the nature of tax changes it is likely to take several years before the impacts of the policy can be properly assessed. In 3-5 years there should be sufficient data to determine how well the rules are working and whether any aspects need to be revisited.

Policy officials maintain strong communication channels with stakeholders in the tax advisory community, and these stakeholders will be able to correspond with officials about the operation of the new rules. If problems emerge, they will be dealt with either operationally, or by way of remedial legislative amendment if needed.