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by email

Dear Judging Panel

ROBIN OLIVER TAX POLICY SCHOLARSHIP SUBMISSION

1 Growing and supporting competitive businesses in New Zealand is a cornerstone policy of the current Government. It has been said that business growth creates sustainable jobs and increases exports around the world (see the Business Growth Agenda for 2014-2015). The formulation of sound tax policy that supports this Agenda is crucial to encouraging confidence in the New Zealand market and ensuring continued investment.

Policy proposal

1 This policy proposal is twofold.

1.1 Ideally, companies should be permitted to buy and sell tax losses.

1.2 In the event that the first proposal is rejected, companies should be entitled to a cash refund equivalent to the tax losses it incurred in the previous taxable period.

Current company loss-offset policy

2 New Zealand's current restrictions on enabling taxpayers to offset losses against their income reflect the policy that only the shareholders who *incur* the losses should be entitled to the *benefit* of those losses. Accordingly, in order for a company to utilise any tax losses in future income years, it must have maintained a set continuity of shareholding (i.e. at least 49% shareholder continuity - see section IA 5 of the Income Tax Act 2007 (*ITA*)). Similarly, a company can only utilise tax loses of another company where the companies are part of the same group (i.e. the group must be at least 66% commonly owned - see section IA 6 ITA).

The current company loss-offset restrictions are distortionary

3 Suppose there are three companies that each invest $200,000 in developing a new product. Each company generates $100,000 of income from the investment in year one but it then becomes apparent that the new product is unviable and makes no more income. However:

3.1 Company A is wholly owned by its parent company, which has made $200,000 net taxable profit in year one from other activities;

3.2 Company B raised the full $200,000 from its shareholders; and

3.3 Company C has made an additional $100,000 net taxable profit from other non-related investments it has engaged in throughout year one.

4 Under the current law, the loss investment by Company A and Company C has an effective cost of $72,000 (assuming a corporate tax rate of 28%). This is because they both have other income available from which they are permitted to offset the losses against. However, because Company B does not have any other income (and may not ever have any income in the future), the loss investment has an effective cost to Company B of $100,000. The fundamental question must be asked: why are Company A and Company C given tax relief, to the effect that their loss investment costs them $28,000 less than Company B?

5 The continuity and grouping loss-offset restrictions in the ITA favour companies in a strong position where they can generate/access other income that can be offset against losses. Smaller companies in a weaker position that may never earn a net taxable profit in the future in this circumstance are effectively 28% worse off.

Proposal 1: allow companies to buy and sell tax losses

6 It is proposed that corporate taxpayers be entitled to sell their tax losses to other corporate taxpayers. This proposal would enable taxpayers, like Company B, to use the market to get the benefit of their tax losses. Tax losses could be sold and the purchasers of the losses would be entitled to deduct those losses from their own net taxable profit. Granted, this regime still requires gains in order to get the benefit of tax losses. However, the use of the losses would not be restricted to the net taxable profit of the person that incurs the losses. They would be open to the cumulative net profit of the New Zealand company tax base.

7 Under this regime there would be no need for a shareholder continuity test. Any change of shareholding would account for the available tax losses and price the share sale accordingly. On the other hand, the loss grouping provisions would still be required in order to ensure that only transfers of tax losses within groups can be undertaken for no consideration.

8 The price at which companies bought and sold losses would be slightly less than the tax benefit the purchaser would receive from using the tax losses. Currently, given a company tax rate of 28%, purchasers would pay any price below 28 cents for every dollar of loss incurred by the seller. Because New Zealand operates a flat corporate tax rate, the price of losses would have minimal fluctuation due to the unchanging benefit the losses would give companies.

Implementation

9 The implementation of such a system may be done in a number of ways. A simple mechanism for the sale of losses could allow the pure sale of a loss position or entitlement to losses. The losses could be sold either directly to the purchaser or through an intermediary. If there was a concern that it would be too hard to ensure

that the sale prices were "arms-length" then it could be a requirement that any loss sales be made through a regulated intermediary.

10 Alternatively, losses could be sold only in the context of share sales or mergers. In other words, rather than allowing taxpayers to sell a stripped loss, the sale could be restricted to sales where the losses are sold together with an asset.

Advantages of allowing sale and purchase of losses

11 If implemented, the proposal to allow the sale and purchase of tax losses:

11.1 ensures that all companies are able to access the benefits of tax losses (places Company B on an even playing field with Company A and Company C);

11.2 assists capital raising for new venture capital business due to the reduced risk of investment;

11.3 does not substantially offend the policy that only persons who incur losses should be entitled to the tax benefit of those losses. In fact, it could be argued that it supports this policy. It ensures that every corporate taxpayer that incurs losses is able to get the benefit of those losses. Inevitably, the difference between the purchase price of the losses and 28 cents in the dollar will represent a benefit of the losses that the purchaser acquires without incurring the loss;

11.4 does not give the acquirer a "windfall" gain because the acquirer is still required to pay an "arms-length" price for the losses;

11.5 there would be no further need to enforce the continuity of shareholding provisions and carry-forward provisions. This is because it would be advantageous for companies to sell their losses immediately after they have been recognised at the end of the taxable period; and

11.6 gives corporate taxpayers a mechanism by which they can get immediate relief from cash-flow problems. This is often encountered by start-up companies which generally make significant losses early in the development phase without guarantee of income in the future.

Disadvantages to allowing sale and purchase of losses

12 The primary disadvantage of this proposal is the significant loss of revenue the Inland Revenue could suffer. Currently, there are many losses that are not utilised that effectively "die" with a company. If implemented, the income tax received from companies could have the effect of being equal to the cumulative net taxable profit in aggregate of every company in New Zealand. This disadvantage is a major drawback to the proposal. However, although a significant consideration, revenue received from tax policy proposals should not always be a *determining* factor. One could argue that, under the current regime, Inland Revenue is receiving a windfall gain providing limited benefit to the market.

13 Other disadvantages of the proposal include:

13.1 the heightened incentive for companies to create artificial losses;

13.2 the administrative burden of ensuring that tax losses are purchased and sold at arms-length prices; and

13.3 the increased complexity of this system compared to the current system. There would need to be three steps in order to allow a company to use another unrelated companies losses. First, Inland Revenue would need to approve the loss making company's losses for the relevant period. Secondly, there would need to be a sale to a third party, which is monitored in order to ensure the sale is at arms-length. Finally, Inland Revenue would offset the third party's income against the newly acquired losses.

Proposal 2: provide a cash refund for losses incurred

14 If it were the case that Proposal 1 was not accepted then, alternatively, it is argued that corporate taxpayers should be granted periodic tax benefits (in the form of a cash receipt) for losses. They would receive the tax value of losses in the tax period in which it makes a net tax loss (i.e. a company that made a $100 loss in the year end 31 March 2014 would receive $28 in cash from Inland Revenue).

15 Proposal 2 could provide an effective mechanism for Inland Revenue to give effect to the policy of helping relieve loss making companies, while limiting the fiscal effect of allowing companies to sell or "cash out" the full value of their losses. It could achieve this by allowing loss making companies to cash out a set portion (say, 75%) of their losses incurred. The remainder of the losses (say 25%) that have not been cashed out could be available for offset in future income years *if* the company makes a net taxable profit. This may be an appropriate middle ground.

Advantages and disadvantages of allowing corporate taxpayers to cash-out their losses

16 The advantages and disadvantages of this proposal are similar to Proposal 1. However, this proposal could be more advantageous because it is simpler to implement. All that would be required is an assessment that the company's losses for that period are legitimate. It is also simpler to enforce. Inland Revenue could impose income tax on all income at the end of a taxable period without the need to consider whether the taxpayer can claim losses from previous periods or from other corporate taxpayers.

17 This Proposal could also be considered more disadvantageous from a fiscal point of view, because Inland Revenue would be making cash payments to taxpayers annually.

18 It is acknowledged that Proposal 2 has similarities to the recent proposals in the Taxation (Annual Rates for 2015-16, Research and Development, and Remedial Matters) Bill for allowing companies to "cash-out" certain losses incurred as a result of "R&D expenditure". However, it is unclear how restrictive the definition of "R&D expenditure" will be. The definition will inevitably preclude a large portion of legitimate losses incurred by loss making companies that may not ever earn any income in the future.

Concluding remarks

19 To comprehensively argue a proposal of this magnitude would require significantly more analysis than is possible in the limited space available for this initial proposal. If this proposal is selected to be expanded on further there are a number of issues that would require close examination. These issues include:

19.1 how to limit the significant reduction in tax revenue;

19.2 the oversight required for a market engaged in trading tax losses. This could include the role an intermediary could play drawing analogy with tax pooling intermediaries. It could be possible for Inland Revenue to be this intermediary taxing a margin from each sale;

19.3 further ways to ensure that companies are not able to create artificial losses;

19.4 ways to market this benefit to potential overseas investors in New Zealand; and

19.5 exploring the possibility of raising New Zealand's company tax rate to compensate for the lost revenue.

20 I look forward to hearing your response.

Yours faithfully

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