A CASE STUDY ON PROBLEMATIC TAX BENEFIT LAWS AND WHAT WE CAN GAIN FROM A PRINCIPLED APPROACH TO TAX POLICY DESIGN

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Introduction

Throughout this research, it has become apparent that income tax law is teeming with relevant principles which should be factored into tax policy drafting. Despite this, there is surprisingly no coherent gathering of these principles which discusses them in relation to one another. From this, stems a commonality of tax policy creating negative externalities. Without a document which brings these many principles together, tax policy designers cannot hope to achieve sound policy.

This dissertation extracts the many principles from various sources, forming a list of the principles which should be upheld in tax legislation. It then assesses this list against a case study of four problematic areas of income tax law to determine remedial options:

1. The deductibility of expenditure under the 'general permission';
2. The deductibility of feasibility expenditure under the 'capital limitation';
3. The loss carry-forward provision; and
4. The 'shareholder continuity' rule.

This dissertation is structured in four parts. Part 1 (Chapter 1) begins by unearthing an array of principles and policy considerations and discusses how they interrelate. This formulation of policy considerations creates a yardstick to assess the four tax rules addressed in this dissertation. It then explains some important preliminary context on basic tax rules and features of new businesses to lead the way into the discussions of Parts 2 and 3.

Part 2 (Chapters 2 – 3) addresses the first two aforementioned problematic areas of tax law– both issues of tax deductibility. Chapter 2 outlines the issues with the general permission, then considers options for reform to resolve those issues. Chapter 3 explains the issues under the capital limitation when applied to feasibility expenditure, then analyses the Government's proposed reform and contemplates ways to improve it.

Part 3 (Chapters 4 – 5) addresses the latter two problematic areas of tax law, which are concerned with loss benefits. Chapter 4 outlines the concerns with the disadvantages for companies under the loss carry-forward provision and considers reform options that would negate these disadvantages. Chapter 5 then deals with the issues for companies under the shareholder continuity rule for tax loss benefits.

Part 4 (Chapter 6) brings together the analysis from Parts 1 – 3 to conclude how the process for tax policy design could be improved to prevent future tax policy from creating negative externalities.

Part 1

Despite the unquestionable importance of tax in providing Governments with revenue to provide public service, tax policy is often contentious. The competing principles involved in tax policy design are the likely culprits. Officials must balance these principles if they hope to produce sound tax policy. New Zealand lacks an organised, easily digestible reference to tax principles, making the designing of sound tax policy a daunting task.

In this Part, I outline the most important considerations for tax policy design and formulate somewhat of a yardstick for assessing tax policy. It will also highlight some important differences between new enterprises compared to mature ones. To set the context, this Part will also describe some fundamental forms of tax treatment.

I <u>Key Concepts and Tax Rules</u>

Tax law differs from other kinds of law. In the words of Sir Ivor Richardson "what makes tax work both special and fascinating is the mix of policy, principle and pragmatism." [1] Tax is the outcome of a political process, but functions under the guidance of principles, and requires consideration of how tax policy will work in practice. A further complication for tax is that income tax is "a wholly artificial universe constructed by law".[2] Accordingly, tax policy design is a complicated process informed by countless distinctive priorities.

The result is a murky-watered collection of competing principles which may or may not feature in the design of any given tax policy. This chapter will attempt to distil these principles in an ordered fashion to paint a coherent picture of how sound tax policy ought to look. It will also outline some core tax treatments to provide an adequate foundation for the discussion throughout the case studies. Finally, it will highlight some key features of new businesses and how they generally differ from mature ones.

A *Principles in Tax Policy Design*

There are three broad bedrocks of traditional tax policy: equity, efficiency, and administrative feasibility and simplicity.[3] Any well-reasoned tax policy ought to consider these critical features. Analysing tax policy involves fleshing out these bedrock elements and weighing them against each other.

Equity in tax policy is a complicated feature. It can be viewed both in the sense of providing equitable welfare outcomes through the distribution of revenue and in the context of fair treatment and equitable tax consequences for taxpayers. Equity in the context of taxpayer fairness is primarily linked to the fact that 'a good tax system should [ensure that] taxes paid reflect ability to pay'.[4] The 'ability to pay' principle gives rise to two notions of fairness and equity — vertical and horizontal equity.[5] Vertical equity encompasses the idea that taxpayers

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[1] Sir Ivor Richardson Foreword to Sawyer (ed) Taxation issues in the Twenty–First Century (2006).
[2] Sian Elias "Righting Environmental Justice" (2014) Resource Management and Theory 47.
[3] Victor Fleischer "A Theory of Taxing Sovereign Wealth" (2009) 84 N.Y.U.L.Rev. 440 at 498.
[4] *A Tax System for New Zealand's Future* (Victoria University of Wellington, Report of the Victoria University of Wellington Tax Working Group, January 2010) at 59.
[5] Julia Kagan "Income Tax Term Guide – Vertical Equity" (28 July 2019) Investopedia <https://www.investopedia.com/>.

with higher income levels are subject to more tax in dollars than those with lower income levels. Horizontal equity is the idea that taxpayers that are the same should pay the same.[6]

Efficiency is an essential feature of any tax code. This principle is concerned with minimising the deadweight loss caused by the tax system, as well as preventing tax policy from distorting economic decisions. Positive business behaviour should not be deterred by tax policy in a way which inhibits economic growth. This feature focuses on what tax policy causes taxpayers to do and whether it encourages efficient or innovative behaviour to contribute to economic growth. Economic efficiency alone is not sufficient to determine policy.[7]

The final feature of the traditional bedrocks, administrative feasibility and simplicity, is about minimising the cost of tax policy by reducing the administrative and compliance burden. Michael D'Ascenzo explains that tax simplicity reduces the dead weight of compliance costs in the economy. It also motivates higher levels of voluntary compliance with the tax system.[8] Tax policy should be as simple as possible without introducing tax loopholes or opportunities for arbitrage.[9] Linked to this, Adam Smith included certainty as one of the four maxims of sound tax policy in 1776.[10] Why sound tax policy should be certain is intuitive. Businesses should be sure of their tax obligations, so they can plan, comply, and avoid penalties.

D'Ascenzo goes on to explain that unfortunately, the objectives of equity, efficiency, administrative feasibility and simplicity are not always aligned. In policy development, trade-offs between these criteria are often necessary.[11] From its roots, tax policy design is an art of trade-offs.

An extremely important tax principle which underpins many of the general tax principles is the integrity of the tax system. Government officials who design tax policy must uphold the integrity of the tax system.[12] The concept of the integrity of the tax system is a fuzzy notion

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[6] Julia Kagan above n 6.
[7] John Creedy "Reflections on 'A Tax System for New Zealand's Future'" (2010) 17 AGENDA 63 at 68.
[8] Michael D'Ascenzo *Institutions and Simplicity - An Australian Perspective* (SSRN, UNSW Presentation to Institutions and Simplicity Symposium, September 2014) at 1.
[9] "Taxation: Efficiency and Equity" This Matters <https://thismatter.com/>.
[10] The Wealth of Nations, Book V, Chapter II, Part II, Appendix to Articles I & II, 861 [h12].
[11] D'Ascenzo, above n, at 1.
[12] Tax Administration Act 1994, s 6(1).

which is not concretely defined. The Tax Administration Act defines the integrity of the tax system, without limiting its meaning, as including:[13]

- The public perception of that integrity;
- The rights of persons to have their liability determined fairly, impartially and according to law;
- The rights of persons to have their individual affairs kept confidential and treated with no lesser favour than the tax affairs of other persons;
- The responsibilities of those administering the law to maintain the confidentiality of the affairs of taxpayers; and
- The responsibilities of those administering the law to do so fairly, impartially, and according to law.

From this concept is pressure on the Government to ensure transparency and confidentially, to administer the law fairly and objectively, and importantly, to monitor and prevent tax arbitrage. Some of these obligations are inherently linked to tax policy design. For example, drafting tax policy to prevent excessive tax avoidance upholds the integrity of the tax system by maintaining the public perception of that integrity. The integrity of the tax system represents more than just democratic tax enforcement. It is also vital for society's general willingness to voluntarily comply with tax obligations. With over 3.5 million taxpayers in New Zealand,[14] voluntary self-assessment of tax liability is essential for administration costs sake. An optimistic public perception of the integrity of the tax system has the benefit of promoting voluntary tax compliance.

As a general proposition, tax treatment is symmetrical.[15] In basic terms, if inflows are taxed, the opposite should be said of outflows. For example, revenue is taxable, but revenue-related expenses are deductible. Alternatively, capital gains are not taxed, but capital losses cannot be tax deducted. A departure from symmetry may create economic distortions and cause unnecessary bias in the tax system. Bias in the tax system means that if there are tax benefits in one area of the economy, there will likely be a shift of resources there from other areas. For example, asymmetrical tax treatment in the forestry industry may decrease the total tax liability

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[13] Section 6(2).
[14] “Who pays income tax… and how much” (2017) The Treasury <https://2017.budget.govt.nz/>.
[15] James Coleman “Tax update [reviews measures to deal with black hole expenditure]” (2013) 5 NZLJ 170 at 170.

for forestry taxpayers. This tax advantage makes forestry more desirable, creating a bias that may shift taxpayers to forestry from other industries. Unless otherwise justified, such bias results in tax playing more of a role in decision making than it should.

In contrast, sometimes tax deliberately assigns bias to particular investment choices as a tool to encourage specific behaviour or positive externalities. Tax often reflects what we value in society.[16] A prime example is the tax-exempt status that is available to qualifying charities.[17] The positive externalities of a tax policy also contribute to whether it is sound policy. However, social incentives via tax should not justify undermining the other principles of sound tax policy.

The Tax Working Group formed six desirable principles for assessing whether tax policy reform is sound.[18] This framework brings together many of the principles so far discussed:

1. Efficiency and growth
2. Equity and fairness
3. Revenue integrity
4. Fiscal cost
5. Compliance and administration cost
6. Coherence

To summarise this framework, tax policy should maintain efficiency and minimise impediments of economic growth. That is, the tax system should avoid unnecessarily distorting the use of resources or causing biases toward one form of investment over another.[19] The tax system should be fair and should consider that the burden of tax differs across individual taxpayers. Equity also demands that taxpayers should not be entirely free to choose whether they are subject to taxation. It should minimise the opportunity for tax arbitrage and provide sustainable revenue to the Government. Tax policies should mitigate opportunities for excessive tax avoidance and prevent loopholes. Tax avoidance is not illegal per se and taxpayers are entitled to order their affairs in ways which mitigates tax liability. However, this harms the public perception of the tax system's integrity. Any reforms should be affordable for the Government to implement and compliance with any tax policy should be as simple and as

[16] Kitty Richards “An Expressive Theory of Tax” (2017) 27 Cornell L.J.&Pub.Pol’y 301 at 305.
[17] Income Tax Act 2007, s CW 42(1).
[18] Above n 5, at 15.
[19] At 15.

low cost as possible. Finally, individual reform within the tax code should make sense in the context of the tax system as a whole. Described as a legal construct,[20] tax arguably should also cohere with other important legal principles where possible.

A final principle to bear in mind is responsiveness. Ian Ayres and John Braithwaite highlighted responsiveness as a critical regulatory theory.[21] Based on this theory, regulations should be responsive to the regulated parties and their context. Tax policy should move beyond a one-size-fits-all framework.[22] This links to equity and fairness. The different circumstances for different businesses should be factored into determining tax liability wherever possible. The importance of responsiveness also extends beyond the initial passing of legislation. If tax policy results in unforeseen disadvantages to large groups of taxpayers, or if market conditions change, Parliament should recognise that and respond to taxpayer needs through necessary reform.

To conclude with an overview, tax policy design should aim to:

1. Promote equity and fairness;
2. Factor in the special circumstances of different groups of taxpayers;
3. Promote efficiency and growth;
4. Be administratively feasible and simple;
5. Be certain and clear;
6. Keep compliance costs low;
7. Avoid generating unnecessary bias for resource allocation unless for a justified tax incentive;
8. Result in symmetrical tax results unless otherwise justified;
9. Uphold the integrity of the tax system by promoting the public perception of that integrity;
10. Be coherent with other areas of tax law and other important legal concepts; and
11. Be indefinitely responsive.

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[20] Elias, above n 2.

[21] Ian Ayres and John Braithwaite *Responsive Regulation: Transcending the Deregulation Debate* (Oxford University Press, Oxford 1992).

[22] Ian Ayres, above n 22.

By no means is there an expectation for all tax policy to satisfy each and every principle. The conflicting nature of many of them makes perfect tax policy unattainable. Even at a basic level, these many conditions for sound tax law exemplify the dilemmas which tax policy designers face. When viewed from this holistic perspective, it becomes clear that perfect tax policy is somewhat of an anomaly.

There are apparent clashes between these principles that require balanced trade-offs in policy design. For example, revenue integrity may result in increased compliance and administration costs. Equity and fairness may conflict with coherence. At times, one principle will have to concede to another. When a principle concedes, this should be acknowledged and justified. Such acknowledgement holds those who design tax policy to account and invites justification for why particular principles have conceded. It also opens doors to scrutiny of tax policy which unnecessarily fails to meet particular tax policy principles.

B *General Tax Rules*

A tax benefit reduces the amount of tax a taxpayer would ordinarily pay. The Government often awards tax benefits for situations it wants to encourage.[23] This paper will address four areas of tax law which bar businesses from realising tax benefits, and which undermine many important tax policy principles. These are:

(1) The deductibility of expenditure under the general permission;[24]
(2) The treatment of feasibility expenditure under the capital limitation;[25]
(3) The loss carry forward scheme;[26] and
(4) The shareholder continuity rule.[27]

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[23] "Definition of tax benefit" Cambridge Business English Dictionary <https://dictionary.cambridge.org/>.
[24] John Packham "A lesson for us all" (13 February 2015) John Packham Chartered Accountants Limited <https://www.jpca.org.nz/> explains that the "general permission" broadly allows expenditure to be deductible if it is: incurred in deriving assessable income or incurred in the course of carrying on a business for the purpose of deriving assessable income.
[25] Geoff Clews and Vivian Cheng "Castles on a Cloud" – Deductibility of Feasibility Expenditure" Geoffrey Clews Barrister <https://www.taxcounsel.co.nz/> defines "feasibility expenditure" as the term generally used to describe expenditure incurred to determine the practicality of a new proposal.
[26] Under this scheme, taxpayers can carry the value of their loss forward to offset the profits in subsequent years.
[27] "Carrying company losses forward" Inland Revenue < https://www.ird.govt.nz/> explains that the shareholder continuity rule requires 49% ownership of a company the remain consistent between the year the loss was incurred and the year the loss is used to offset future profit.

A general explanation of the treatment of income, expenses and losses is necessary before delving more deeply into these tax benefits and their associated issues. In New Zealand, income is taxable,[28] while expenses and losses are deductible for calculating tax liability.[29] To determine tax liability, total expense deductions[30] are subtracted from annual gross income[31] to result in either a tax loss (if deductions exceed revenue) or a net income (if revenue exceeds deductions).[32] If a business incurs a loss, the tax balance of that loss is carried forward into the future to offset net income, thereby reducing taxable income.[33] These tax benefits make expenses and losses more bearable to businesses and prevent tax from further exaggerating business costs and losses. Where expenses or losses are substantial, the outflow from the business is less significant if a tax benefit emanates from them. By allowing deductions of certain expenditure and the carrying forward of losses, tax policy is decreasing the risks of investing and innovating.

Unfortunately, the tax policies awarding these tax benefits contain certain barriers which indirectly exclude many businesses from deriving them. This paper will explore four areas of tax law which undermine businesses ability to derive tax benefits. While this is problematic for businesses generally, this fact bites particularly hard at new businesses and start-ups.

C *Common Features of New Businesses*

As will transpire throughout the case studies in Parts 2 and 3, many of the issues arising under poorly drafted tax policies have disproportionately negative effects on new businesses in comparison to mature ones. It is important to outline the features which often place new businesses at a disadvantage in deriving tax benefits. Some notable features causing disadvantages include:

1. Loss susceptibility
2. High expenses and establishment costs
3. Relatively large shareholder fluctuations
4. The incurrence of expenditure before formulation of a clear income-earning structure.

[28] Income Tax Act, s BB1.
[29] Income Tax Act, pt D.
[30] Section BC 3.
[31] Section BC 2.
[32] Section BC 4.
[33] Section AI 3(4).

How these features exasperate some of the shortcomings in tax policy will become evident throughout the case studies in Part 2.

In the years following business introduction, income is generally low, while expenses are high. New businesses which have innovative products or services at their core may also possess early loss-susceptibility as an intrinsic characteristic, as their establishment may rely upon significant investment costs. Early losses are particularly prominent in some industries, forestry and viticulture being examples, because of the necessary capital acquisition and innovative preparations.

Costs at introduction, such as research and development expenditure and feasibility expenditure, can be significant. Successfully entering into a business requires preliminary planning and forecasting, which may require considerable resources and investment. Businesses may incur these expenses before any income is derived. New businesses often need to attract investors to raise capital. Attracting investors is a tool to increase cash flow to enable new businesses to undertake projects or to turn losses into profits.

Research shows that start-ups are integral to economic growth and job creation.[34] However, by nature, start-ups are subject to either an 'up or out' route. They either advance or exit the market. Subject to their survival, young firms create jobs to a disproportionate extent by expanding their establishments.[35] However, around 47% of jobs created by start-ups in the United States are eliminated by market exits in the first five years of operation.[36] Though this data represents new businesses from the United States, we can predict that the trend is similar in New Zealand, indicating the importance of supporting new businesses in their first years of operation.

[34] John Haltiwanger, Ron Jarmin and Javier Miranda *Who Creates Jobs? Small vs. Large vs. Young* (National Bureau of Economic Research, Working Paper 16300, August 2010).
[35] At 26.
[36] At 24.

Part 2

Part 2 outlines two areas of tax law which bar businesses from deriving tax deductions. It will assess whether the current tax policies adequately meet the principles discussed in Part 1, as well as considering what changes could improve the policy to better meet these principles.

As highlighted in Part 1, expenses can be deducted from taxable income. An expense will be deductible if it satisfies the general permission[37] and if it is not barred from deduction under any of the general limitations.[38] Chapter 2 will address the issues with the general permission for new businesses and the possible reform options. Chapter 3 will discuss the issues with the current treatment of feasibility expenditure under the capital limitation. It will then evaluate the soundness of the Government's proposed reform.

[37] Income Tax Act, s DA 1.
[38] Section DA 2.

II The General Permission

An expense is only deductible if it is a qualifying expense. To qualify, an expense must fall under at least one of the limbs of s DA 1 (the "general permission").[39] Limb 1 of the general permission requires the taxpayer to incur the expense in deriving their assessable income.[40] Limb 2 requires the taxpayer to incur the expense in the course of carrying on a business for the purpose of deriving their assessable income.[41] The predecessors of the Income Tax Act also imposed this structure for determining deductibility.[42]

A *Limb 1*

Under limb 1, there must be a sufficient connection or nexus between the expenditure in question and the income-earning process. The leading cases in New Zealand establish that there must be a sufficient nexus between the expenditure incurred and the income-earning process for the expenditure to be deductible.[43]

Richardson J in *Banks* stated that there must be an existing relationship between (1) what the expenditure gained or sought to gain, and (2) the income-earning process. He noted that one cannot specify in concrete terms the kind and degree of connection required for each case.[44] Agreeing with Dixon J in *Amalgamated Zinc (de Bavay's) Ltd*,[45] Richardson J said the assessment is a matter of fact and degree and looks rather to the scope of the operations or activities and the relevance of the expenditure than to the purpose in itself.[46] *Grieve* supports this when Richardson J states that whether the nexus is satisfied is a matter of fact, and degree, depending on the nature of the activities carried on and the taxpayer's intention in engaging in those activities.[47]

Similarly, in *Buckley,* Richardson J stated a deduction is only available where the expenditure has the necessary relationship both with the taxpayer in question and with the gaining of their

[39] Income Tax Act, s DA 1(1).
[40] Section DA 1(1)(a)(i).
[41] Section DA 1(1)(b)(i).
[42] *See* Income Tax Act 1994 No 164 and Land and Income Tax Act 1954.
[43] *CIR v Banks* [1978] 2 NZLR 472 (CA) and *Buckley & Young Ltd v CIR* [1978] 2 NZLR 485 (CA).
[44] *CIR v Banks* [1978] 2 NZLR 472.
[45] *Amalgamated Zinc (de Bavay's) Ltd v FC of T* [1935] 54 CLR 295 at 309.
[46] *CIR v Banks,* above n 45.
[47] *Grieve v CIR* [1984] 6 NZTC 61,682 (CA).

assessable income. This involves the identification of the relationship between the advantage gained or sought to be gained by the expenditure and the income-earning process, which required true determination of the true nature of the payment.[48]

The criteria for general permission is summarised well in *Cox* as follows:[49]

1. A sufficient relationship must exist between the expenditure, and the taxpayer and their generation of assessable income. This requirement focuses on the relationship between the advantage gained or sought by the expenditure and the income-earning process, which in turn requires one to focus on the true character of the payment;
2. It is a matter of degree and a question of fact whether such a sufficient relationship exists.

B *Limb 2*

Expenses are assessable under limb 2 if incurred in the course of carrying out a business or venture with the intention of making a profit, irrespective of whether a profit is a realistic expectation.[50] As an example, entertaining clients comes at a cost, which is not sufficiently connected to the income-earning process to fall under limb 1. However, it could be considered necessary for securing future potential clients.[51] Limb 2 is considerably roomier than the former, as it does not require a nexus to a particular income-earning structure. Accordingly, new businesses that are yet to form an income-earning structure may still be able to satisfy the general permission through limb 2.

C *Issues with the General Permission*

The general permission assessment protects the integrity of the tax system. It prevents private expenses from being loosely credited to business expenditure. Leaving loopholes to incur tax deductions on non-qualifying expenditure erodes the tax base and undermines the public perception of the integrity of the tax system.

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[48] *Buckley & Young Ltd v CIR* [1978] 2 NZLR 485 at 108.
[49] *Cox v Commissioner of Inland Revenue* (1992) 14 NZTC 9,164.
[50] *Grieve v CIR*, above n 48.
[51] *Tax Acts* (online ed, Thomson Reuters, Wellington, [2020]) at 9.2.5.

However, it is uncertain as to whether a preliminary venture would satisfy the general permission. The analysis of the case law implies that an income-earning process is necessary for the limb 1 assessment. This requirement may be problematic for new businesses. There may be scenarios where a soon-to-be business owner undertakes feasibility assessments and incurs expenses before the establishment of their income-earning structure. Limb 2 leaves the position relatively unclear as to whether this scenario would satisfy the general permission. The statutory wording of limb 2 does not identify what amounts to the carrying on (or purpose of carrying on) of business. The Act defines business as including any profession, trade or undertaking carried on for-profit[52] and includes any recurring income-earning activity.[53] There is no clear indication as to when business commences for the purpose of the general permission assessment.

Complicating this further is the disparity between *Trustpower Ltd* and *Grieve. Trustpower Ltd* recently highlighted the possible issue with the general permission:[54]

> Section DA 1 denies deductibility to feasibility expenditure for a new, or an entirely separate, business venture which is not underway at the time the expenditure is incurred. If activities are undertaken to decide whether or not to enter into a business, the expenditure will lack the required nexus to a business and s DA 1 will not be satisfied. In determining whether a business has commenced, the commitment of the taxpayer to that business – or, as the Interpretation Statement puts it, whether "a decision has been made to enter into that business or activity" – is highly material.

Based on this reading, there is scope for expenditure to fail the general permission, barring a deduction, if the taxpayer (a) does not yet have an income-earning structure, and (b) has not yet committed to a business. How can a taxpayer incur expenditure with the intention of deriving a profit, if there is no commitment to business? Consequently, those considering entering into new business risk being unable to deduct preparatory costs. This approach to the general permission would put new businesses at an unfair disadvantage and would fail to acknowledge the sensitive position taxpayers face leading up to business launch.

[52] Income Tax Act, s YA 1.
[53] Section DD 1
[54] *Trustpower Ltd v CIR* [2016] 1 NZLR 155 at 169.

On the other hand, the holistic approach of *Grieve* would likely lead to a different result. Under the *Grieve* assessment, one could argue that any exploration of business opportunities or assessment of options will objectively be for the intention of generating a profit, irrespective of whether there has been a commitment to the business venture. Under this orthodox assessment, business establishment costs would be more likely to satisfy the general permission.

The resulting question is which approach prevails for determining whether business establishment expenses are tax-deductible under the general permission. The crux of the Supreme Court decision in *Trustpower* was assessing the applicability of the capital limitation,[55] rather than the general permission. Further, *Trustpower* dealt with a new business opportunity of an existing business, while Grieve dealt with a new business. It is therefore unlikely that the Court intended its outline of the general permission to alter the position of *Grieve* in any significant way.

Overall, the proper application is somewhat undetermined, leaving a concerningly unclear position. With the contrast between *Grieve* and *Trustpower*, prospective entrepreneurs may be unsure as to whether they will satisfy the general permission to derive a tax benefit for their preliminary expenses. This precariousness is firstly an issue for business certainty. When determining whether to launch a business, taxpayers should be in a position that allows them to predict the associated costs. New businesses are unable to do this if it is unclear as to whether preliminary expenditure will satisfy the general permission. This issue is concerning for industries with high initial costs, such as forestry, as the tax benefits from preliminary costs may be considerable.

With this uncertainty comes the risk of being unable to derive the tax benefit from expenses. Taxpayers may react to this by reducing the extent of their business preparations. Accordingly, the lack of clarity around the general permission for preliminary expenditure also undermines sound business practice, efficiency and growth. As highlighted in Part 1, new businesses are integral for job creation and economic growth. Reform addressing these matters should be considered to support prospective entrepreneurs better.

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[55] Income Tax Act, s DA 2(1).

D *Reform*

To resolve the uncertain position around whether preliminary expenditure satisfies the general permission, Parliament could reform the wording of s DA 1 to align with *Grieve* more clearly. This is important to give taxpayers peace of mind when determining the true cost of business establishment.

This concern should be balanced with the need to uphold the integrity of the tax system. Widening the general permission in this way may open the door for tax arbitrage. It is difficult to determine whether a taxpayer had the intention to derive a profit through the expenditure if there is not yet a commitment to a business. Consequentially, this tax policy may open floodgates to taxpayers deriving tax benefits by fraudulently depicting an intention to incur a profit, when in truth the expenditure is unrelated to the business. This arbitrage opportunity would erode the tax base and undermine the public perception of the integrity of the tax system. However, the private limitation, which denies deductions for expenditure to the extent to which it is of a private or domestic nature[56] may prevent the arbitrage opportunity.

Implementing this reform, though not significant, would redress the issues with certainty and efficiency and growth. It would also likely uphold the integrity of the tax system due to the private limitation. The adjustment would take an existing tax treatment and merely clarify it to ensure a nuanced approach when dealing with soon-to-be businesses.

It may be that Parliament is not prepared to tamper with the general limitation, given it is so fundamental in New Zealand income tax. In this case, Parliament could alternatively legislate an exception for businesses under 24 months. This exception could allow a retrospective deduction for expenditure incurred in the preparations for establishing a business if that business does eventually come to fruition. For example, consider a prospective business that takes 18 months to commit to the business venture. Under this reform, the expenditure associated with the establishment of that business that had previously failed the general permission would later have the test reapplied as though the business had always existed.

[56] Section DA 2(1)

An exception for new businesses would pragmatically acknowledge their special circumstances as they invest in exploratory studies and due diligence before a business structure is committed to. Ultimately, this would increase the survival of new businesses. This reform option would also be robust in protecting the integrity of the tax system, as it limits opportunities for tax arbitrage.

Against the principles of sound tax policy, either a clarification of s DA 1 or an exception for new businesses would be an improvement to the current position. These approaches importantly promote innovation and growth and uphold the integrity of the tax system. The clarification of *Grieve* to secure the inclusion of prospective businesses should be the favoured approach, as it would be a less dramatic alteration to the current position. Remaining close to the existing approach is important given the fundamental nature of the general permission.

III Deductibility of Feasibility Expenditure

Where new businesses satisfy the general permission, the expenditure may still be non-deductible if it falls within one of the general limitations.[57] One of the general limitations is the capital limitation. The capital limitation denies a deduction for expenditure to the extent that it is capital in nature, as opposed to revenue in nature. This approach often bars feasibility expenditure from being tax-deductible.[58]

As a simple distinction, capital expenditure is generally the expenses used to acquire, upgrade and maintain capital assets. Revenue expenditure is the expenses used in the day-to-day operations of the business.[59] It can often be unclear what side of this distinction expenditure falls.

This chapter will explain the traditional capital limitation, then will delve into the treatment of feasibility expenditure under the capital limitation given the recent tightening of the assessment in 2016. It will highlight the factors of this approach which undermine sound tax policy principles with particular consideration of the issues for new businesses. Finally, this chapter will analyse the Government's proposed solution to the treatment of feasibility expenditure and will assess whether this solution amounts to sound tax policy.

A *The Capital Limitation*

BP Australia Ltd is the leading position for the capital versus revenue distinction.[60] Accordingly, there are three matters to be considered: (a) the character of the advantage sought by the expenditure (b) the manner in which it is to be used, relied upon or enjoyed (c) the means adopted to obtain it.[61] Expenditure is normally of a revenue nature if its purpose is to meet regular trading costs and if it relates to regular business demand.[62]

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[57] Income Tax Act, s DA 2.
[58] Section DA 2(2).
[59] Steven Bragg "The difference between capital expenditures and revenue expenditures" (6 January 2020) Accounting Tools <https://www.accountingtools.com/>.
[60] *Trustpower Ltd v CIR*, above n 55 at [37] referring to *BP Australia Ltd v Commissioner of Taxation (Cth)*[1966] AC 224 (PC) at 264–265.
[61] *BP Australia Ltd v Commissioner of Taxation (Cth)*[1966] AC 224 (PC) at [394] citing Dixon J in *Sun Newspapers Ltd v Federal Commissioner of Taxation* [1938] 61 CLR 337 (HCA).
[62] *Sun Newspapers Ltd v Federal Commissioner of Taxation* [1938] 61 CLR 337 (HCA).

If expenditure is deemed to be capital in nature, that expenditure is included in the value of the asset. So though not deductible immediately, it is included in the depreciation expense, which will gradually be deducted. The down-side to this is that depreciation deductions are spread over a long period of time and are eroded by inflation.

The assessment of whether an expense is capital in nature is a balancing exercise. Employing a balancing exercise for the capital limitation assessment allows flexibility to account for the circumstances of the taxpayer. This assessment positively adopts less of a blanket approach than the other areas of tax law discussed in this paper. There is room for pragmatism in this approach. Dixon J's passage in *Hallstroms Pty Ltd* captures the pragmatic assessment under the revenue and capital distinction. He says:[63]

> The solution to the capital versus revenue distinction is not to be found by any rigid test or description. It has to be delivered from many aspects of the whole set of circumstances.

He then goes on to say the answer depends on:[64]

> what the expenditure is calculated to effect from a practical and business point of view, rather than upon the juristic classification of the legal rights… employed in the process.

One would ordinarily assume this passage implies the capital limitation is responsive to the particular circumstances that a new business faces to support them. However, the pragmatic design historically seen in the capital limitation has not been maintained by the courts in the case of feasibility expenditure. The Supreme Court in *Trustpower* did away with this pragmatic design for feasibility expenditure, opting for a strict assessment that leaves most feasibility expenditure non-deductible.[65]

B *Feasibility Expenditure*

Feasibility expenditure is expenditure incurred when determining whether a potential project is practicable or possible. Examples include engineering surveys, market research and

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[63] Dixon J in *Hallstroms Pty Ltd v FCT* (1946) 72 CLR 634 at [648]
[64] At [648], per Dixon J.
[65] *Trustpower Ltd v CIR,* above n 55.

obtaining professional advice.[66] The Act offers no guidance on the deductibility of feasibility expenditure. Consequently, its deductibility is determined by a two step-process in accordance with the general permission provision of s DA 1[67] and the general limitations of s DA 2.[68]

Trustpower has recently developed the assessment under s DA 2 in a way that captures far more feasibility expenditure in the capital limitation. To understand this development, it is first necessary to outline the position prior to the Supreme Court's ruling.

1 Prior to Trustpower

Before *Trustpower,* the 2008 Interpretation statement highlighted that feasibility expenditure incurred principally for the purpose of placing a taxpayer in a position to make an informed decision about an asset was said typically not to be on capital account. However, once the taxpayer committed to proceeding with the acquisition, then any further expenditure would be attributed to the asset to be acquired and would be on capital account.[69] This approach was known as the commitment test. Accordingly, there was a distinction between feasibility expenditure incurred before, and after committing to proceed with the acquisition.[70]

This original approach to the capital limitation in the context of feasibility expenditure was consistent with the treatment of expenditure generally. The approach was pragmatic and factually dependent. It allowed deductions for feasibility expenditure if the particular circumstances made it sensible to do so.

For example, a new vineyard owner may want to purchase a harvester. Before doing so, they may pay for an analysis of the cost to benefit difference between handpicking and harvesting. On the one hand, the cost of prior research may be attributed to the cost of the harvester, making it capital in nature and non-deductible. On the other hand, this cost may be viewed as a regular business expense, deeming it revenue in nature. In the latter scenario, the expenditure would be tax-deductible.

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[66] Clews, above n 26.
[67] Income Tax Act, s DA 1.
[68] Section DA 2(1).
[69] Interpretation Statement 08/02: *Deductibility of feasibility expenditure* Tax Information Bulletin Vol 20, No 6 (July 2008) at 20.
[70] Mark Keating *Trustpower: the black hole problem continues* (Walters Kluwer, New Zealand Tax Planning Reports, 10 November 2016) at 18.

Under the original approach to the capital limitation, there would have been scope to convincingly argue that there was a sufficient connection between this kind of feasibility expenditure and the everyday operations of the vineyard. Understanding the different options for harvesting is an important business decision directly linked to the heart of the business's income-earning process. This inference would likely be enough to classify this market research as revenue in nature and tax-deductible. This is especially so given there had been no clear commitment to the acquisition of the harvester at the point the expenditure was incurred. This result makes sense, as until the harvester is committed to, it is too far removed to begin attributing costs to the would-be asset.

2 The Current Approach

A rigid gloss was added to the conventional capital versus revenue test by the Supreme Court in its ruling in *Trustpower Ltd.*[71] The Court did away with the commitment test, resulting in the broader capital limitation for feasibility expenditure.[72]

Trustpower is an electricity generator and retailer. At the time of the case it generated about half of the electricity it would sell and would purchase the remainder. Trustpower had a 'development pipeline' of 200 potential power plant projects. The pipeline assessed the feasibility of these projects to help inform Trustpower as to whether it should invest in the plants.[73] As a part of the development pipeline process, Trustpower applied for and obtained resource consents. Trustpower acquired the consents on the basis that they would be material in assessing the feasibility of the projects. Extensive additional investigation was needed before Trustpower would commit to any project. Market conditions at the time would also be a material factor. Trustpower claimed $17.7m of expenditure in relation to four of these consents to be deductible. Trustpower argued they indistinguishable from the existing business activities (s DA 1) and did not amount to capital expenditure (s DA 2).[74]

[71] *Trustpower Ltd v CIR*, above n 55, at [47].
[72] At [47].
[73] At [1]–[2].
[74] At [1]–[3].

The High Court had held that the resource consents were on revenue account.[75] The Court of Appeal said they were on 'capital account'.[76] Both of these decisions were based on the 2008 Interpretation Statement released by Inland Revenue.[77] The matter was appealed in the Supreme Court to determine whether the consents were on revenue account and deductible or whether it was on capital account and non-deductible.[78]

The Supreme Court accepted that a rational decision to proceed with the projects could not be made prior to the consents being obtained,[79] but that on the other hand, the consents were tangible progress to the eventual completion of the projects.[80] The consents were expensive in terms of money and time. The case turned on whether the intermediate steps (namely the obtaining of resource consents) towards the completion of the capital projects (being the power plants) were appropriately treated as referable to, and as advancing, those projects, even though:[81]

(a) when those steps were taken, Trustpower had not decided whether it would complete the projects; and
(b) any decisions to do so after the obtaining of the consents would be based on extensive additional investigations and market conditions.

In addressing this issue, the Supreme Court abandoned the commitment test set out in the 2008 interpretation statement.[82] Instead, the Court concluded that the feasibility expenditure crossed the line to being capital in nature once it *materially advanced* the project in question.[83] Young J stated: [84]

> Some feasibility expenditure referable to proposed capital projects might sometimes be deducted. We do not, however, see such deductibility as extending to external costs incurred in respects which do, or were intended to, materially advance the capital project in question.

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[75] *Trustpower Ltd v Commissioner of Inland Revenue* [2013] NZHC 2970 at [154]–[157].
[76] *Commissioner of Inland Revenue v Trustpower Ltd* [2015] NZCA 253 at [85]–[103].
[77] The High Court and Court of Appeal used: Inland Revenue Interpretation Statement: Deductibility of Feasibility Expenditure (ISO8/02, June 2008), see *Trustpower Ltd v CIR* [2016] NZSC 91 at [7].
[78] *Trustpower Ltd v CIR,* above n 55.
[79] At [2].
[80] At [71].
[81] At [3].
[82] At [47].
[83] At [13].
[84] At [13].

In the Court's view, the consents amounted to tangible process towards eventual completion of the projects which could not be built without them.[85]

The 2017 Interpretation Statement was later published to align with the *Trustpower* decision. This publication firstly states that whether feasibility expenditure is capital or revenue in nature rests on the facts of each case.[86] It then highlights two situations where feasibility expenditure might be deductible:

1. Where the expenditure is not directed towards a specific capital project, which is a matter of fact and degree.[87]
2. Where expenditure is so preliminary, that it cannot be said to advance the specific project materially.[88]

The result is a considerable widening of the total feasibility expenditure, which will be non-deductible for failing the capital limitation.

Reflecting on the example of the new vineyard owner, the treatment of the market research would likely be different under the new materially advancement test when compared to the old commitment test. Under the material advancement test, it is more likely the market research would be non-deductible. Investigating the cost to benefit difference between handpicking and harvesting would be directly linked to progressing the decision of whether to purchase the harvester. Based on the Supreme Court's reasoning, the research may be considered enough to materially advance the acquisition of the new harvester.

C *Issues with the Current Approach*

The Court in *Trustpower* gave no compelling rationale for departing from the commitment test. The judges merely acknowledged the commitment test was not helpful.[89] One can only speculate that the intended benefit of widening the scope of the capital limitation for feasibility

[85] *Trustpower Ltd v CIR*, above n 55, at [2]-[3].
[86] Interpretation statement 17/01: Income tax – Deductibility of feasibility expenditure", *Tax Information Bulletin,* Vol 29, No 3 (April 2017) at 15.
[87] At 17, notes that this situation will likely be where there has been no identification of a project.
[88] At 18.
[89] *Trustpower Ltd v CIR*, above n 55, at [47]

expenditure is in the interest of commercial certainty. If most feasibility expenditure is not tax-deductible, then a taxpayer can be more confident their feasibility expenditure will form part of the capital cost. With this certainty, businesses can plan accordingly. However, the prioritisation of certainty creates problems when assessed against the other principles required for sound tax policy design.

The Minister of Revenue explained that "tax consequences should not be an obstacle to businesses innovating and pursuing opportunities for growth."[90] Impediments to efficiency and growth are key downfalls of the material advancement test. Decreasing the scope of deductible feasibility expenditure decreases the tax benefit inflow to businesses. Consequently, this reduces the cash which businesses can use to innovate and grow. Further, under the current test, the value of feasibility assessments to business owners drops.[91] If feasibility expenditure is predominantly non-deductible, exploring new investment options is more expensive.

The risk of sacrificed tax benefit makes firms less likely to take risks with acquiring assets or adopting new processes or business models.[92] It may also lead to business decisions that would be perverse but for the tax implications. For example, Project A may be more lucrative and productive than Project B. However, Project A may require $100,000 more feasibility expenditure than Project B. Without an available tax deduction for feasibility expenditure, project A may be unviable, and the taxpayer may undertake the less productive project B instead.

The scenario worsens when the expenditure is barred from a deduction, and the project in question is abandoned entirely. In this scenario, there is no immediate deduction for the expenditure, nor is there a future deduction on the depreciation expense. This is a prime example of asymmetrical tax treatment. If expenditure is treated as capital and barred from a deduction despite there being no resulting capital, it is known as blackhole expenditure. Blackhole expenditure is more prevalent under the material advancement test. The asymmetrical treatment of blackhole expenditure distorts the economy and impedes

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[90] Judith Collins "Budget 2017 addresses black hole expenditure" (26 May 2017) The official website of the New Zealand Government <www.beehive.govt.nz>.
[91] Steve Summers "Feasibility ruling: uncertainty for business" BusinessNZ <https://www.businessnz.org.nz/>.
[92] Tax Working Group, New Zealand "Future of Tax: Final Report Volume I – Recommendations" (21 February 2019).

innovation. Blackhole expenditure clashes with the purpose of the capital limitation; to prevent deductibility for the cost of acquiring an asset. It is an arbitrary result.

Blackhole expenditure and the resulting asymmetry allows tax to play more of a role in decision making than it ought to. The risk of blackhole expenditure exposes the tax system to bias. In practice, this bias requires the expected pre-tax return of an investment that may result in black hole expenditure to be higher than the expected pre-tax return of a project that does not include such expenditure.[93] Businesses will be more likely to opt for projects which will not risk blackhole expenditure.

The material advancement test encourages poor business behaviour. Firstly, businesses may cut back on feasibility studies to avoid the additional cost of blackhole expenditure. This conduct can lead to under-planned projects and detrimental business decisions.[94] Secondly, the material advancement test incentivises business owners to complete projects that do not make economic sense because the studies have crossed the line to being capital in nature. Once feasibility expenditure reaches the point of capital classification, abandonment of the project is more costly.[95] Finally, barring deductibility of feasibility expenditure makes beginning a project riskier, as tax benefits are more likely to be sacrificed. Even if a capital asset results, the deductible depreciation expense is delayed. The risk of non-deductible feasibility expenditure may make it undesirable for business owners to even attempt to expand, explore new projects, or penetrate new markets. Overall, this behaviour is negative for efficiency and economic growth in New Zealand. Tax policy should be encouraging wise business choices and should not punish businesses who exercise their due diligence and consider the feasibility of investments before proceeding.

These concerns are encompassed by looking more in-depth at the previous example of the vineyard owner. The taxpayer may attempt to cut back on feasibility expenditure by following through with the acquisition of the harvester before feasibility studies have fully informed them. The business would then acquire the harvester with little understanding of the risk associated with the investment. Alternatively, the taxpayer may discover that handpicking

[93] *Tax Working Group Information Release* (the Tax Working Group, position paper for session 21, 26 October 2018) at 19.
[94] At 19.
[95] At 19.

would be a more valuable form of harvesting. If the feasibility expenditure is non-deductible, the harvester may, overall, be the cheaper investment, as this would prevent blackhole expenditure and would enable future deductions for the depreciation on the harvester. On the other hand, the business owner may decide to instead sit passively with their existing business activities rather than undertake expensive feasibility studies.

Equity and fairness is another core tax policy principle being undermined by the current approach to the deductibility of feasibility expenditure. It fails to acknowledge that all the issues highlighted in the preceding paragraphs are heightened for new businesses due to their unique features. Because new businesses are at the onset of their business, they are more likely to incur feasibility expenses for new assets. New businesses are also likely to be investigating multiple assets at once to assess them against each other. In this case, only one project may be committed to. Accordingly, new businesses are relatively more exposed to feasibility expenditure and the issues previously discussed are of heightened influence for new businesses. The current test also fails to address that to new businesses deductibility of feasibility expenditure may be a significant contribution to their survival. Equitable tax policy would factor in these disadvantages to new businesses and would allow flexible treatment in support of them.

D *The Government Proposal*

There are several serious concerns with the material advancement assessment against the sound tax policy yardstick. These issues must be redressed to better meet the various essential tax principles. By widening the amount of deductibility of feasibility expenditure, business owners will also be more willing to search for new project proposals, to engage in feasibility studies before implementing them and may be more inclined to identify if a project is not commercially practicable. Fortunately, the Government has undertaken some preliminary steps in redressing this unsound tax policy.

In late 2019, the Government published an information release outlining its initiative to allow for more comprehensive deductions of feasibility expenditure.[96] The Government later

[96] Grant Robertson and Stuart Nash "Tax initiatives to support the Government's Economic Plan" (December 2019) Inland Revenue Department Tax Policy <https://taxpolicy.ird.govt.nz/>.

announced its intention to proceed with allowing deductions for feasibility expenditure for businesses.[97] The Taxation (Annual Rates for 2020-21, Feasibility Expenditure, and Remedial Matters) Bill was introduced in early June of 2020.[98] It contains several key proposals, including an amendment to the treatment of feasibility expenditure. The proposed amendment aims to provide a more straightforward, low compliance cost approach for businesses to deduct their feasibility expenditure to promote productive growth and to redress the distortion of blackhole expenditure.

The proposed legislation would override the capital limitation for feasibility studies incurred for capital assets which never come to fruition.[99] Where annual feasibility expenditure for the year is less than $10,000, it will be immediately deductible in the year the expenditure was incurred.[100] For larger feasibility projects, businesses will be able to spread the deduction over a five year period. If the relevant project does come to fruition, a clawback provision will apply, which will immediately recall the tax benefit awarded under this exception.[101]

Unfortunately, this proposal only addresses blackhole expenditure. It fails to address the fact that feasibility expenditure is nearly always deductible, which causes issues even if the relevant asset eventuates. Therefore, additional adjustments should be made in order to bring deductibility of feasibility expenditure back in line with expenses generally.

1 Benefits of the Bill

This change to the treatment of feasibility expenditure is a positive one which improves the tax policy under some of the competing principles. The proposed approach would remedy the distortionary issues and blackhole expenditure. The Bill successfully eliminates blackhole expenditure by allowing deductions when no capital results from the feasibility expenditure. It prevents the scenario where revenue expenditure is treated as capital, despite there being no related existing capital. The proposed change would resolve the negative distortionary impact of undermined symmetry and would better align the treatment of feasibility expenditure with the purpose of the capital limitation.

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[97] "Tax initiatives announced to support businesses" (23 September 2019) Inland Revenue Tax Policy News <https://taxpolicy.ird.govt.nz>.
[98] Taxation (Annual Rates for 2020-21, Feasibility Expenditure, and Remedial Matters) Bill (273-1).
[99] Clause 16.
[100] Clause 16.
[101] Clause 11.

The clawback provision upholds the integrity of the tax system, as it requires taxpayers to return the tax deduction should the project ever be finalised. This provision prevents taxpayers deferring projects to acquire a tax benefit. A trade-off for the clawback provision is that enforcing that clawback will create a higher administrative burden for Inland Revenue. However, this is necessary to prevent tax arbitrage.

Resolving the distortionary impacts on blackhole expenditure reduces the bias in the tax system. It reduces the influence that tax plays in business decision making. Blackhole expenditure is removed from the equation when deciding which project is the most lucrative. Feasibility studies also become cheaper. This encourages the use of feasibility studies in business decisions. Thus, business decisions will be better informed and will have a more accurate assessment of related risks. Overall, certainty around risk will make taxpayers more inclined to consider new projects and ventures. Further, the increase in cash from the wider access to the tax benefit provides more opportunity for investment and growth. Overall, the proposal will encourage innovation, efficiency and growth in New Zealand.

2 Improvements to the Bill

One downside of the Bill is that the five-year gradual payment delays the tax benefit to businesses. With equity and fairness in mind, it should be acknowledged that this delay erodes the value of the tax benefit via inflation and undermines symmetry. Further, an immediate tax benefit may be influential in the survival of new businesses. While the $10,000 threshold of expenditure which is immediately deductible offsets this issue slightly, this is an insignificant figure. If feasibility expenditure were to be treated coherently with the deductibility of general expenditure, the total feasibility expenditure would be immediately deductible. To better promote efficiency and growth, the Government should consider allowing immediate deductions, in line with the treatment of general expenditure, or it should consider boosting this $10,000 de minimis threshold upwards; potentially to $100,000 per annum.

The final key concern with the Bill is that it does nothing to widen the scope of deductible feasibility expenditure in the case where the asset does eventuate. The material advancement approach left by *Trustpower* classes almost all feasibility expenditure capital in nature, even if it is a regular business cost. Even under this proposed reform, feasibility expenditure will be

barred from deductibility far more strictly than other forms of expenditure. This inflexibility is arbitrarily inconsistent with the treatment of general expenditure and fails the spirit of the capital limitation, which is designed to be adaptable to business needs. The commitment test prior to the *Trustpower* case offered a far more flexible approach which considered the circumstances surrounding the relevant expenditure. It allowed for pragmatism in response to different business needs. The commitment test to feasibility expenditure more accurately reflects the capital versus revenue distinction. Accordingly, the Bill could be improved by reinstating the commitment test, with statutory guidance on the difference between expenditure before and after the point of commitment. This would allow for flexibility, but would also offer sufficient guidance to ensure business certainty.

Overall, the Bill is sound policy and is a reasonable balance of the competing principles. While there are limits to particular principles, the Bill does not run in contradiction to any principles to a concerning extent. The scope of the Bill is limited, however, as it does not resolve the excessively broad scope of the capital limitation when an asset does result. There should, therefore, be an addition to the proposed reform that re-adjusts the classification of feasibility expenditure.

Part 3

In Part 3, the analysis moves into two areas of tax law which often deny companies their tax loss benefits. As alluded to in Part 1, when a company makes a loss, that loss may be used to offset future taxable liability. Before determining taxable income, any outstanding tax loss benefit from previous income years is taken off the taxable income, thereby reducing income tax liability. This process occurs every income year until the tax benefit from that loss is entirely exhausted.[102] For example, if a company makes a $100,000 loss in year one, and derives $50,000 of income per annum in years two and three, that company could use the $100,000 loss to offset the two subsequent net incomes to the effect that the company does not pay tax in either of the ensuing years. The rationale behind this is that if taxpayers pay tax on their income, but never get relief for their losses, overtime, they will pay more than the statutory rate of tax.[103] The ability to carry forward losses to offset future tax is to recognise the financial outflow that occurred to the taxpayers in the years which companies operated at a loss.

There are two orthodox ways to derive value in losses. One is to carry the loss back to offset prior profits (carry-back scheme). The other is to carry the loss forward to offset future profits (carry-forward scheme). New Zealand utilises the carry-forward scheme.[104] Chapter 4 will address the issues that can arise for companies under the loss carry-forward scheme and will question whether adjustments could be made to the legislation to improve the situation for new companies.

Additionally, to derive a tax loss benefit, the shareholder continuity rule must be satisfied. New companies find this rule unduly difficult to meet. Chapter 5 outlines what this rule entails, its issues, and will consider how the New Zealand approach to this could be improved to be sounder tax policy.

[102] Income Tax Act, s IA 3(4).
[103] "Loss Carry Backs" (April 2020) Inland Revenue Department Tax Policy <https://taxpolicy.ird.govt.nz/>.
[104] Income Tax Act, s IA 3(4).

IV The Loss Carry-Forward Scheme

Where a taxpayer sustains a loss in any year, that is where allowable deductions exceed gross income,[105] those losses can be carried forward until the amount of net income in future years matches the amount of losses carried forward[106] (the 'loss carry-forward scheme'). In the case of a natural person, the losses are carried forward until extinguished in that way or the taxpayer dies. In the case of a legal person, a company, the losses can be carried forward until the company ceases to exist. However, there is a caveat to that. While a company for legal purposes exists until it is removed from the companies register,[107] for tax purposes that perpetual life is modified in respect of losses carried forward. Losses can only be carried forward so long as a minimum level of shareholder continuity is maintained.[108] When continuity is not maintained, the loss is extinguished.

A *Issues with the Loss Carry-Forward Scheme*

The carry-forward scheme is sound policy in a general sense. Largely, it upholds symmetry, does not excessively impede on innovation and growth, does not distort the economy, maintains the integrity of the tax system, and is simple and certain. However, there are critical issues with this approach that are specific to companies. When viewed from the perspective of struggling companies, this tax policy is inequitable and increases the risk of innovating.

Because of company structure, if a company incurs a loss but is liquidated before it derives a subsequent profit, the tax loss benefit dissolves with the company. For look-through companies or businesses which are not companies, a loss may be used to offset all of the taxpayer's other income until that loss value is exhausted. The tax from the business could be used to offset the owner's future personal income, even if that income is unrelated to the business loss. A company, on the other hand, is a legal entity in its own right and is separate from its shareholders.[109] Accordingly, when a company incurs a loss, the shareholders cannot use that loss to offset their other income tax.

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[105] Section BC4(3).
[106] Income Tax Act, Flowcharts B1 and B2.
[107] Companies Act 1993, s 15.
[108] Income Tax Act, s IA5.
[109] Companies Act, s 15.

When a company incurs a loss, it must wait until it eventually earns a profit before it may use that loss benefit to offset tax liability. A key issue with this is that not all companies will recover from a loss to reach the point of making a profit. This often means that the tax loss benefit dissolves with a company.

The carry-forward approach is unpragmatic in response to the differences between the structure of a company and the structure of other businesses. Loss benefits are aimed towards ensuring taxpayers do not pay more than the statutory tax rate. Why, then, does the tax policy leave the company at risk of sacrificing its tax benefit to the result of paying more tax than their statutory obligation? The reason comes down to the premise of separate legal identity. The tax treatment of companies recognises their separate legal identity. This means that tax losses sustained by a company belong to the company and not the shareholders. The shareholder continuity rule identifies the company with its shareholders so that losses cannot be carried forward by a company if the shareholding changes. On the other hand, the tax benefit of losses cannot be used by either the company or its shareholders (investors). This results in the company paying more tax than if the loss had been sustained by an individual or a partnership. It seems logical, therefore, that a pragmatic response, similar to that of the shareholder continuity rule, could follow here to ensure shareholders are not required to pay more than the statutory tax rate over time.

Another issue with the loss carry-forward scheme is that it does not factor in the unique circumstances of new companies, such as their propensity to many consecutive losses in early years, their chance of market exit and the importance of immediate cash flow for survival. Only being able to derive loss benefits in future profitable years postpones the benefit, reducing immediate cash flow. The value of the loss benefit is also eroded by inflation. Receiving a tax benefit sooner may be the difference between survival and failure of some new companies. Not providing the immediate tax benefit to struggling companies limits their ability to innovate, or improve their operations to survive. As a result, new companies are at a heightened risk of never realising their tax loss benefit. These factors are all significant strikes against the soundness of the carry-forward scheme.

B *Recommended Reform*

Parliament should reform the loss carry-forward scheme to ensure it is more responsive to the issues created for companies and to better meet the sound tax policy principles. Reform should first acknowledge the arbitrary unfairness companies face under the carry-forward provision due to their structure. A provision could be enacted which grants tax credits representing unrealised tax value to the shareholders upon the dissolution of a company. Tax credits would be for the amount of any tax loss benefit attributed to the shareholder based on their shareholding at the point the loss was incurred. The value of the tax credits would be available for the shareholder to offset their future personal income tax in the same manner normal business owners can.

This would be a more pragmatic approach to the arbitrary result that presently requires shareholders to pay more tax than the statutory rate. Problematically, this runs contrary to the premise of separate legal identity, meaning this provision would be incoherent with wider legal principles. However, this pragmatic response would justify the brief departure from separate legal identity.

Implementing this reform is one step towards improving the current loss carry-forward approach. An additional response would be needed if the Government wished to redress the detrimental impact of delayed tax-loss benefits specifically for new companies. The benefit of fast cash relief in response to a loss was something that was in the Government's contemplation when it introduced the COVID-19 response legislation which introduced a loss-carry back provision for losses made between the 2019 – 2021 income years.[110] The introduction of the temporary loss carry-back scheme was to support businesses in the current uncertain economic environment.[111] New companies, by their nature, arguably face uncertain economic environments that justify a similar preferential treatment as businesses under the COVID-19 response. However, a carry-back scheme would unlikely assist new businesses as they will unlikely have a historic profit to deduct the loss from.

Instead, Parliament could consider enacting an exception for new businesses to immediately deduct losses derived in their first three years of business. New companies would be paid cash for their tax loss benefit from the Government immediately after making a loss for the financial

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[110] Income Tax Act, s IZ 8.
[111] "COVID-19 Temporary loss carry-back scheme" Inland Revenue <www.ird.govt.nz>.

year. When the company does become profitable, there would no longer be a tax loss balance available. Essentially, the tax loss benefit would be realisable sooner. This would be to acknowledge the sensitive financial position of new companies, boosting fairness. The immediate cash benefit would increase the survival rate of new companies and would boost innovation and growth.

There are very detrimental risks that would come from this. For example, if new companies do not reach profitability, they will never have a future profit to offset this tax loss benefit. This would reduce the tax base and the Government's revenue for welfare and other needs. New companies should not be granted a tax benefit if there is the risk they will never reciprocate by paying tax on future net income. Allowing this would create asymmetrical results and would undermine the public perception of the integrity of the tax system. While an attempt to acknowledge the differences between new and mature companies is desirable, there would be arbitrary flow-on effects in practice. Accordingly, this reform would fail to meet the necessary tax policy principles.

Overall, granting shareholders tax credits for tax benefits owed at the point the company is wound-up would improve the carry-forward provision. However, allowing immediate tax deductions for new companies would create more detrimental tax policy.

V **The Shareholder Continuity Rule**

Under s IA 5, a company's tax loss component is carried forward in a loss balance only if the company meets the minimum continuity requirements.[112] That is, 49% of ownership must remain consistent between the year the loss is incurred, and the year the benefit is to be derived.[113] If ownership changes by more than 51% the loss is no longer transferable to subsequent tax years, and the value in the loss is lost.

The mischief which the shareholder continuity rule seeks to redress is tax-loss trading. Tax-loss trading is where a profitable company buys a small company that is operating at a loss. The purpose of buying such a company is to use its loss to offset the purchasing company's profits in future years, decreasing tax liability. The issue with this is that the profitable organisation never suffered from the loss in the year that it occurred. Tax-loss trading undermines the integrity of the tax system. The premise is that only those who suffered from a loss should receive the matching benefit of that loss.

In *Challenge Corporation Ltd,* the taxpayer purchased the loss-making subsidiary from a parent company. This subsidiary company had no assets or debts but had a sizeable tax-deductible loss. This enabled the taxpayer to transfer the new company's loss to the other subsidiaries, thereby reducing the taxpayer group's assessable income.[114] The Privy Council found that the taxpayer had observed the express provisions of the Act, and even though the aim was to reduce tax liability, the transaction was not illegal.

This was in line with the *Keighery* right of choice principle[115] which permits taxpayers to order their affairs in a way that does not attract tax, as long as they are within the law. The reference to the right of choice is in line with Lord Tomlin's famous words in *Duke of Westminster*:[116]

> Every man is entitled if he can to order his affairs so as that the tax attaching under the appropriate Act is less than it otherwise would be… however unappreciative the

[112] Income Tax Act, s IA 5 (1).
[113] Section IA 5 (2).
[114] *Challenge Corporation Ltd v Commissioner of Inland Revenue* [1986] 2 NZLR 513 at 514.
[115] *W P Keighery Pty Ltd v Federal Commissioner of Taxation* [1957] HCA 2.
[116] *Inland Revenue Commissioners v Duke of Westminster* [1936] AC 1 HL at 19.

> Commissioners of Inland Revenue or his fellow taxpayers may be of his ingenuity, he cannot be compelled to pay an increased tax.

Parliament's response to *Challenge Corporation Ltd* was to impose the shareholder continuity rule, thereby closing the loss trading loophole. This was designed to uphold the integrity of the tax system.[117] However, this same door was closed to businesses genuinely wanting to raise significant capital, creating a trade-off between the either equity raising or the loss benefit. This in itself undermines the integrity of the tax system through blatantly disregarding the vast number of genuine shareholder movements over 49% that are barred by the shareholder continuity rule.

A *Issues with the Shareholder Continuity Rule*

The Government's response to *Challenge Corporation Ltd* is a prime example of the fact that changes to tax policy have a ripple effect, implicating wider areas of the economy. The current shareholder continuity rule prioritises the integrity of the tax system over supporting innovation, efficiency growth and equity by applying a blanket ban on tax loss benefits where ownership changes by over 49%. Not only is this treatment asymmetrical, but it also poses an evident disparity with the fundamental company law principle of separate legal identity. Further, eliminating a tax loss benefit impedes on innovation in New Zealand. This is especially the case for new companies, which are particularly in need of the cash benefit of tax losses.

A Government fact sheet on the matter highlights the issue in an example:[118]

> A start-up firm offers microphone and webcam software. It has been making large losses in recent years. However, it now wants to scale up significantly, given that more people are working from home and using videoconferencing. Banks are unwilling to lend to the firm without it having a solid revenue base. The firm has approached several investors and has received an offer from an investor to inject millions of dollars into the firm in return for a 75% stake in the business.

[117] Tax Administration Act 1994, s 6 (2).
[118] "Supporting small and medium sized enterprises during the COVID-19 crisis" (15 April 2020) Beehive <https://www.beehive.govt.nz/>.

Under the current shareholder continuity rule, the value of the loss would be extinguished if this offer was accepted. The current shareholder continuity rule disregards the scope of genuine ownership changes that are motivated by the need to turn annual losses into profits. For example, a loss-making business may find that it is in their best interest to acquire new capital in order to undertake an investment which will decrease operating costs and increase income. The present rules would punish this sound business decision by imposing a harsh sacrifice of the existing tax loss benefit. The test, in its current form, is arbitrary. Preventing loss trading via a 49% threshold has negative impacts on companies that generate capital for legitimate purposes. The bright-line test may provide certainty, but at the detriment of symmetry, coherence, innovation, efficiency, and equity.

An issue with the shareholder continuity rule is the incoherence with related legislation. The premise of the shareholder continuity rule is entirely inconsistent with the principle of separate legal identity. By preventing tax loss trading, this legislation is ignoring the foundational idea that the loss made by the company belongs to the company and not the shareholders. Therefore to apply a continuity test based on shareholder consistency runs incoherently with company law. While this is not a deeply important principle for sound tax policy, this inconsistency may not be necessary and is therefore undesirable.

Another issue with denying tax benefits is that it risks undermining symmetry. If profits are taxed, then losses should be compensated by a tax loss benefit. If symmetry is not upheld, the taxpayer will pay more than the statutory rate of tax. This is an inequitable result that undermines horizontal equity as well as the public's perception of the integrity of the tax system.

Concerningly, denying tax-loss benefits when there has been a change in ownership increases the cost of losses, which increases the risk of going into business. It also discourages companies from taking risks, which consequently impedes upon innovation and growth in New Zealand. Furthermore, if a company makes a loss, it will be less likely to acquire capital to redress this loss in fear of sacrificing the tax loss benefit. Companies may instead acquire unnecessary debt rather than looking for new investors.

On the other hand, the sacrifice of a tax loss benefit will make the business a less valuable investment for investors. After the global financial crisis, it became challenging for small

business and entrepreneurial start-ups to obtain funds for expansion and seed capital.[119] There may be similar implications for businesses under the recessionary climate following COVID-19. To aggravate this blow, the companies which do generate capital, risk diluting shareholder interests in breach of shareholder continuity.[120] For courageous entrepreneurs and small business owners looking to expand in this environment, there should be sources of funding available to assist their innovation. Capital accumulation and innovation are two key drivers of economic growth,[121] so this approach is a clear breach of the efficiency and growth principle of sound tax policy.

The negative externalities created by the shareholder continuity rule are exaggerated when applied to start-up companies. It is typical of start-ups to make losses in the early phases of operation, and there are frequent shareholder movements.[122] Attracting new investors in the introductory years of business is a normal response to a trading loss or an opportunity for growth. This combination of factors result in new companies being disproportionately disadvantaged by the shareholder continuity rule as they are more likely to breach the 49% threshold.

The result is arbitrary in this sense, as it does not factor in the distinctive circumstances faced by businesses early in market introduction. When new companies do become profitable, their tax loss benefit can often be compromised, making it harder for them to get through their first years of business. The flexibility to shift shareholdings and to raise capital in the early stages is essential for new companies to grow in the market, as it is an alternative to acquiring debt. This tax policy imposes bias on debt as a form of cash generation, rather than equity.

Deriving a tax loss benefit may be the difference between struggling start-ups surviving in the market and failing. This unsupportive treatment of New Zealand entrepreneurs has a far-reaching negative impact on the New Zealand economy through possibly reducing innovation, competition and growth.

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[119] Lloyd J.F. Southern "The status of small business growth and entrepreneurial start-up capital availability during the current extended economic downturn" (2016) 14 Probl. Perspect. Manag. 8 at 8.
[120] Mathew McKay, Hayden Roberts and Phoebe Adams "Tax loss carry-forward: the "same or similar business" test" (Friday 19 June 2020) Bell Gully Publications <www.bellgully.com>.
[121] Robert E Litan and others *Rules for Growth: Promoting Innovation and Growth Through Legal Reform* (Ewing Marion Kauffman Foundation, Missouri, 2011) at 36.
[122] Mathew McKay, above n 121.

B *The Government Proposal*

The shareholder continuity rule should be changed through legislation to comfortably prevent loss trading without undermining important tax policy principles. The Government has signalled a potential legislative change to soften the shareholder continuity rule. The details of the reform are yet to be finalised, but there appears to be strong support for New Zealand to adopt the Australian 'same or similar business' approach.[123] Inland Revenue expects the change to cost the Crown $60 million a year.[124] The Government intends to pass legislation before the end of March 2021, and for it to apply to the 2020/21 and later income years.[125]

1 The Australian Approach

Australia applies a far more flexible test with its shareholder continuity rule than New Zealand's current treatment. The test applies if there has been more than a 50% change in ownership of the company.[126] Under this business continuity test, businesses are entitled to their tax loss benefit if the former and present enterprises are considered the same or similar. This assessment involves comparing the former and present company identity, continuity of business activities, and the use of assets to generate assessable income.[127] Each of these factors should have regard to the context of the given case.

In deciding if the business is similar, there are four factors which must be considered:[128]

1. The extent to which the assets were used in both the current and former business;
2. The extent to which the activities and operations which its current business generated assessable income are also the activities and operations from which the former company generated assessable income;
3. The identity of the current and former businesses; and
4. The extent to which any changes to the former business result from the development or commercialisation of assets, products, processes, services or marketing or organisational methods of the former company.

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[123] "COVID-19 (novel coronavirus) - Tax changes to support businesses" (15 April 2020) Inland Revenue <https://www.ird.govt.nz/>.
[124] Above n 124.
[125] "COVID-19 Changes to the tax shareholder continuity rule" Inland Revenue <https://www.ird.govt.nz/>.
[126] Greg Howes "Tax Basics - Program 10: The Deductibility of Current and Prior Year Company Losses" Television Education Network <https://www.tved.net.au/>.
[127] "Increasing access to company losses" (8 July 2019) Australian Taxation Office <https://www.ato.gov.au/>.
[128] McKay, above n 121.

Under the similar business test, even if ownership or control of a company changes, that company may utilise its tax loss benefit against income derived from carrying on a similar business.[129]

The Australian Tax Office Ruling on the matter provided some examples of what would satisfy the similar business test.[130] For example, a bicycle courier company that developed a new bike with insulated compartments built into the frame, which later realised the potential of the new design to deliver food, might satisfy the test. The same company purchasing separate insulated boxes specifically for food delivery to affix to the existing bike design, might not. The key is tracking the development of the former business to the present one and ensuring there is a constant connection between the two. It will still be challenging to satisfy the test where the is a substantially new business activity that had not directly evolved from or does not complement that of the former business.

Reflecting on the prior example of the microphone and webcam firm, under the Australian test, the firm would be able to accept the large investment offer without losing its loss benefit. This is because the firm would not be materially altering the business. The cash injection for the 75% shareholder stake is, therefore, more valuable, as no loss value is sacrificed.

C *Benefits of the Proposal*

The current New Zealand approach fiercely guards the integrity of the tax system and certainty to the detriment of innovation, growth, efficiency, equity, fairness, symmetry and cohesion. There are many reasons that adopting the Australian approach would be an improvement to New Zealand's existing tax policy.

Adopting the Australian approach would soften the test and increase access to tax benefits derived from company losses. Firstly, this improves the symmetry of the tax system by ensuring that most losses receive symmetrical treatment to profit. Increasing access to tax-loss benefits also would raise the total cash available to companies, which they can utilise to

[129] "Tax Talk Monthly June 2019" (June 2019) PricewaterhouseCoopers <www.pwc.com.au>.
[130] Law Companion Guideline LCR 2019/1 The business continuity test – carrying on a similar business at 4.

improve their financial position. More cash opens the door to more innovation, efficiency and business growth.

The Australian approach would allow capital generation where it makes business sense to do so. Tax would, therefore, play less of a factor in deciding whether to acquire debt or equity. The approach removes the bias towards debt and encourages businesses to be more responsive to their trading losses. The result would likely support business success, which would improve New Zealand's economic growth.

The 'similar' approach, as opposed to a 'same' approach, leaves room to gradually develop business activities, meaning there is no detriment to growth or innovation.[131] New companies would be able to revise their income-earning structure to become profitable while still maintaining their tax loss benefit. This invites companies to be more responsive to losses. The approach prevents new businesses from shying away from opportunities. It also increases the value of affected companies in the eyes of investors,[132] as being able to carry forward losses makes a business more valuable.[133] This should make capital more accessible to New Zealand companies. These factors are all beneficial for innovation, efficiency and growth.

This revised policy would also better achieve equity and fairness in the tax system, as it allows flexibility of application to acknowledge the circumstances faced by new companies. Because new companies are less likely to have a 'former' business identity, almost all losses would be tax-deductible. This allows new companies to attract new investors far more freely, which is a equitable acknowledgement of the unique needs of new companies.

The approach is also more cohesive with wider legal principles, such as separate legal identity. Unlike New Zealand's current policy, it is consistent with the idea that regardless of who the shareholders are or how they change, a company remains the same from a legal perspective. Rather than the test being about the shareholders, the Australian approach assesses the continuity of the company. This approach captures the idea that only the taxpayer who suffered

[131] Law Companion Ruling LCR 2019/1, above n 131.
[132] "COVID-19 (novel coronavirus) - Tax changes to support businesses" (15 April 2020) Inland Revenue <https://www.ird.govt.nz/>.
[133] Above n 126.

the loss should be awarded a tax benefit, while still acknowledging that under the concept of separate legal identity, it is the company which suffered the loss, rather than the shareholders.

The shareholder continuity rule was crafted to uphold the integrity of the tax system and prevent tax loss trading. Notably, adopting the Australian same or similar business test would still preclude tax-loss trading. To pass the test, the company must have maintenance of business operations and business developments must be gradual and uphold the former business's identity. Tax-loss trading would therefore require the substance of the company to be maintained.

D *Improvements to the Proposal*

A weakness of the Australian approach is that it deters large jumps of innovation that may create a new identity for a business. To sustain its tax loss benefit, a company would need to ensure it did not significantly stray from its previous identity. This limits the scope of innovation or development opportunities for companies that want to retain their tax loss benefits. Innovation which disrupts the former business identity should not always be punished.

A further downfall of the Australian approach is that it puts a lot of emphasis on the subjective assessment of whether a business is considered the 'same' in terms of its identity or not. For any company which has a change of 50% in the shareholding stake, maintenance of their loss value becomes slightly whimsical. Companies changing their incoming earning processes or operations may be left unconfident as to whether they will retain their loss benefit. This is because the Australian approach requires companies to subjectively determine whether they satisfy the test. Tax loss benefits may be of an influential sum to a company. Ergo, it is important the reform leaves companies in a position where they are able to predict with some certainty whether they will sacrifice their tax benefits.

Returning to the microphone firm example, the 75% shareholder stake would breach the continuity rule, thereby triggering the subjective business continuity test. If they decide they want to shift their business model into installing Zoom Video Communications equipment into offices, it is very uncertain as to whether they would meet the similar business test. This uncertainty is still a concerning result for a company.

To reduce the number of firms which are exposed to this kind of certainty and to target tax loss trading, a higher continuity requirement threshold could be implemented. Once a company's ownership changes by 75% or more, the same or similar business test used in Australia would be triggered. This would allow companies to change their operations how they see fit unless they wish to significantly change their ownership. This approach would remove impediments on innovation, but would also protect against tax loss trading, protecting the integrity of the tax system. To support this, the general anti-avoidance rule (GAAR)[134] would do more in the present day to guard against tax loss trading than in 1986 when the issue of tax loss trading was brought to light. For companies which breach the 75% shareholder continuity threshold, legislative guidance could be utilised to support the assessment of whether they breach the same business test.

To strengthen this reform further, Parliament could adopt the same tax loss credit system for shareholders who lose their tax loss benefit as seen in Chapter 4. This would ensure shareholders are not paying more than the statutory tax rate over time, yet only impedes on separate legal identity on rare occasions.

While New Zealand's current shareholder continuity rule is more 'certain' at face value, it denies the use of value in losses in a way that is quite arbitrary in itself. Therefore, adoption of the Australian approach, paired with an increase in the shareholder continuity requirement threshold, and a tax loss credit distribution would be beneficial reform options to resolve the current issues with the shareholder continuity approach in New Zealand.

[134] "Relationship between double tax agreements and anti-avoidance rules" Inland Revenue Tax Policy <http://taxpolicy.ird.govt.nz/> explains the General Anti-Avoidance Rule effectively overrides other provisions of the tax legislation to deny the tax benefits of an arrangement when a more than incidental purpose of the arrangement is to obtain a tax benefit.

Part 3

The general permission, treatment of feasibility expenditure, loss carry forward scheme and the shareholder continuity rule are all areas of tax law which negatively undermine many vital principles of tax policy. It is concerning that foundational, and readily accepted aspects of tax law are missing the mark on so many important principles.

The following part will focus on how the structure of the tax system allows this inadequacy and where the system could be adjusted to prevent tax policy designers disregarding desirable tax policy principles.

VI Improving Future Tax Policy

The preceding case studies have exposed some considerably detrimental issues with very readily accepted tax policy in New Zealand. It is concerning that these issues have been operating in New Zealand for a considerable length of time. Perhaps viewed by the public as a matter of administration, rather than law, issues in tax law are often habitually followed. Accordingly, it is typically left to officials to engage in reviews of tax policy and to take remedial action. The Income Tax Act has a flexible design. The structure of parts and subparts invites alterations to the law. There are sometimes as many as five amending statutes in a year.[135] This flavour would lead one to assume that income tax policy is responsive when issues with tax policy arise after enactment. With a clear failure to address the four concerns discussed, this appears unlikely. Perhaps New Zealand's tax system needs adjusting to hold legislators sufficiently accountable to the soundness of the tax policy they impose. Arguably an independent review body should be created to apply more pressure on the Government to make amendments of poorly designed tax policy.

To unpack this idea, looking at the tax policy design process in New Zealand would be a helpful start. Tax policy is developed under the guidance of the Generic Tax Policy Process (GTPP). The Government introduced the GTPP to map out the various steps and stages of policy-making as a single process. The purpose of the GTPP is to ensure better, more effective tax policy development which considers key policy elements and trade-offs, such as the revenue impact, compliance, administrative costs, as well as economic and social objectives. The GTPP also builds public consultation into the process at several stages.[136] This process puts compelling importance on consultations and a bottom-up approach to tax policy design.[137] It creates an open, interactive process that ensures tax policy changes are well thought through.[138] The benefit of this user-based design is that tax policy decisions can be fully informed and based on merits, with a reasoned assessment of all the competing tax policy issues. This design intends to improve the quality of tax policy.

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[135] John Prebble "New Zealand Taxation and Taxation Law" (31 March 2015) SSRN <https://papers.ssrn.com/>.
[136] "The Generic Tax Policy Process and the tax policy work programme" Inland Revenue Tax Policy <http://taxpolicy.ird.govt.nz/>.
[137] "Briefing for the Incoming Minister of Revenue – 2011" Inland Revenue Tax Policy<http://taxpolicy.ird.govt.nz/>.
[138] Adrian Sawyer "Reviewing Tax Policy Development in New Zealand: Lessons from a Delicate Balancing of Law and Politics" (2013) 38 ATF 401.

What GTPP lacks is a process for scrutiny of already existing tax policy that may have appeared sound at the point of enactment, but which later reveals unintended negative consequences to certain taxpayers. The tax practices underpinning these four problematic tax rules were embedded in the New Zealand tax code before the adoption of the GTPP process. It is crucial that tax policy is flexible, responsive and pragmatic when exposed to the many different circumstances faced by businesses. As highlighted in the preceding case studies, some of New Zealand's most instrumental tax rules miss the mark when compared against the collection of important principles. It is vital that when tax policy misses the mark, there is someone responsible for identifying and remedying that. Not doing so would allow otherwise 'sound' tax policy to apply inequitable consequences to specific taxpayer classes.

To address this fact, it would be wise to implement an independent body to support tax policy design and the GTPP process. This body could have the power granted by legislation to conduct regular independent reviews of the impacts of tax policy in New Zealand. It could serve a similar function to London's Institute for Fiscal Studies (IFS), which has the mission of promoting effective economic and social policies "by better understanding how policies affect individuals, families, businesses and the government's finances."[139] The purpose of the IFS is to review the UK's taxpayer to consider the likely effects of fiscal policy on every section of the population.[140] Similar to the IFS,[141] the objectives of a New Zealand version would be (1) to be committed to objective analysis, (2) to provide tools to understand and evaluate tax policy, and (3) to be independent of the Government to hold it to account.

Such a body would be tasked with monitoring concerns lodged by disgruntled taxpayers and the public. It would extend the user based policy design process of the GTPP to after a policy has been legislated to maintain the bottom-up approach. The body would publish regular reports highlighting where tax creates consequences which undermine the fundamental principles for sound tax policy. It would also be tasked with regularly reviewing the implementation of the GTPP to ensure it is doing its part to prevent unsound tax policy. One of the first tasks of a new independent body ought to be the publishing of a document which

139 "Homepage – Institute for Fiscal Studies" The Institute for Fiscal Studies <https://www.ifs.org.uk/>.
140 "Institute for Fiscal Studies" (11 February 2020) Think Tank <https://onthinktanks.org/>.
141 John Weeks "We need to talk about the Institute for Fiscal Studies" (22 November 2019) Open Democracy <https://www.opendemocracy.net/>.

discusses the interplay between the important principles in tax policy. This document would be the yardstick adopted for considering whether tax policy is sound. The body ought to be made up of a representative committee that includes tax experts, lawyers, business owners from various industries, as well as iwi representatives. This would allow for a broad understanding of the many interests that may be undermined when unsound tax policy is legislated.

The premise of the body would be to hold the Government to account by shedding light on negative externalities which stem from tax policy. It would ensure that the balanced assessment of principle considerations is sufficiency informed. A review body would give a voice to affected parties to outline the consequences of tax policy based on their circumstances, including their broader social, economic and natural environments. Taxpayers would have a robust opportunity to disclose the impacts of particular tax policy on them. This approach acknowledges the fact that tax policy, though carefully designed, may result in unforeseen negative externalities which should be redressed if possible. The body would act as a backup shield, meaning if unsound tax policy gets past the GTPP, there would be ongoing pressure to redress the issues. By exposing the downfalls of tax policy after enactment, the Government would be made aware of the issues and must take responsibility for failing to redress them. It will promote open and ongoing engagement with tax policy. In doing so, it increases the likelihood of public pressure on the Government to improve the drafting of tax legislation to balance the principles of tax law better.

In the process of implementing an independent body to hold the Government accountable, there are many important considerations that the Government should consider. Michael D'Ascenzo poses some interesting questions that should be confronted:[142]

> Are we establishing another bureaucracy? How do we ensure the body is bi-partisan and operating in the national interest? Could an existing institution be improved instead? Would this cause duplication of roles dealing with the same responsibility? Does the body fit within the concept of responsible government?

Assessing the process of creating an independent review body is outside the scope of this paper. Nonetheless, these questions must in mind for the scoping of its responsibilities and its

[142] D'Ascenzo above n 9, at 6.

processes. Exactly how such a body should be structured and what the answers of D'Ascenzo's questions would be valuable for further research on the topic.

Conclusion

Tax benefits are necessary if Governments wish to uphold a sound tax system. To do otherwise charges a taxpayer more than the statutory tax rate. The general permission, the application of the capital limitation to feasibility expenditure, the loss carry-forward scheme and the shareholder continuity rule should all instil necessary tax benefits to New Zealand taxpayers. To the contrary, these tax rules are barring certain groups of taxpayers from deriving tax benefits without a justification to do so. Resultingly, New Zealand taxpayers seeking to establish or develop their businesses are being penalised. Through the course of these four case studies, it is clear that even the most conventional tax policies can have blatant faults. This research process has shown how irregularly the community acknowledges these faults. There appears to be no robust means for addressing which tax policies are unsound or which remedial action can be taken.

The vast majority of New Zealand taxpayers voluntarily comply with tax laws, meaning following unsound tax policy often become an unquestioned habit. It is therefore important that there are transparent apparatus with which taxpayers can understand the soundness of the tax policies they submit to. The use of reasoned principles in tax policy design is a valuable tool which can be used by taxpayers to determine the soundness of tax laws. The current disarray of tax principles make it difficult to hold officials to account when they draft tax legislation that results in negative externalities. Through conducting an analysis of the various discussion points in tax policy, this dissertation has developed a list of considerations which tax laws should be assessed against. A similar formalised document, with wider reaching principles, and deeper analysis should be published as a tool for questioning the integrity of tax policy in New Zealand.

Implementing a legislative body would carry the spirit of such a document to pressure the Government into taking remedial action for unsound tax policy and to ensure sounder tax policy design in the future. While not every desirable principle will be achieved in a tax policy, the notion of a document for reference makes officials accountable to justify their choice of some principles over others. Essentially, it provides a more transparent, bottom up approach to tax policy design, which extends from the GTPP process and throughout the entire life of tax policy. This is ultimately to create a fairer tax system for New Zealand taxpayers.

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