Tax Working Group
Te Awheawhe Tāke

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Position Paper on Tax Policy
April 2018

Introduction

New businesses are one of the most powerful sources of job creation in an economy.[1] High growth start-ups and scale-ups play an even more powerful role in the creation of jobs and socio-economic wellbeing. [2] Angel and early stage investors and the capital they provide are a critical component in the speed and success of venture growth.

2 Governments around the world support the generation high growth start-up companies. When they do so through revenue levers this is about a focus on headline tax rates and tax incentives. When they do so through expenditure, governments provide sponsored venture funds (eg NZ Venture Investment Fund), grants and programmes to support professional development and connections to expertise, customers and capital (eg accelerators and incubators).

3 Given the impact on social and economic wellbeing, Government policy should create the most conducive environment possible for entrepreneurs, start-up companies and their investors and supporters; an environment supporting risk, allowing and encouraging failure, addressing information asymmetry and supporting connectivity and professional development.

4 Angel Association NZ believes it is not about picking the single most powerful intervention but ensuring the creation of a design-led set of policies to cater for the fact every start-up and founder has a different path to success. It's about acknowledging picking winners is notoriously difficult and that there is a degree of luck and timing inherent in the success of every "Xero".

5 With respect to incentivising venture investment through tax policy specifically it's about:

- governments not "picking winners" themselves;
- addressing investor risk aversion;
- designing policies to remove distortions to behaviour and to incentivise quality investments and the quantity of investments to ensure the generation of a big enough portfolio to surface the winners;
- ensuring awareness and stability so investors know about and can rely on policies being consistently in place; and
- monitoring and evaluating the effectiveness of incentives to ensure the requisite impact and learning.

6 While there is a lack of definitive evidence of a causal relationship between tax incentives and better venture and angel investment outcomes, a 2017 EU Commission report concluded there is compelling enough anecdotal evidence from tax experts and surveys of investors to be able to say tax incentives do have a significant impact on investment decisions.[3]

7 This brief position paper provides an early stage investment perspective on relevant tax policies already in place in New Zealand, touches on policies we would like to see adopted and makes some observations on the lack of a capital gains tax.

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[1] http://www.kauffman.org/what-we-do/resources/entrepreneurship-policy-digest/the-economic-impact-of-high-growth-startups

[2] http://www.scaleupinstitute.org.uk/wp-content/uploads/2017/07/ScaleUpInstitute_SME_Finance_Monitor_2017_MID_RES.pdf

[3] https://ec.europa.eu/taxation_customs/sites/taxation/files/final_report_2017_taxud_venture-capital_business-angels.pdf

Tax policies in place

8 **Research and development tax loss credits** –AANZ provided comments on the R&D tax loss credit regime which allows business losses from eligible expenditure to be cashed out instead of being carried forward at the time of its drafting.[4] Our submission made the following key points about its deficiencies:

- Encouraging the commercialisation of innovation through support for R&D is only one small component of commercialisation. The key component is finding markets for the outcomes of the R&D;
- The regime has a minimal impact on cash flow constraints because R&D expenditure is incurred before the tax losses can be cashed out and most start-ups do not have the cash to spend on the R&D in the first place;
- Some start-ups are not building products and services which fall within the legislation's NZ IAS 38 definition of R&D and in other instances advisors struggle to apply the R&D definitions in the innovation context;
- The wage intensity test dis-incentivises market development and capital-intensive R&D;
- The screening process for claimants is overly complex given the maximum cash benefit is low and the funding is a loan not a grant.

9 That said, the tax loss credits can work well for start-up companies with experienced advisors. The cash received from the IRD is non-dilutive and without the conditions attached to equity funding. The IRD is also to be commended for paying out tax loss credits within 4-10 weeks of returns being filed. The credit is of course "a loan" and given the high failure rate of start-ups the 'credit risk' is with IRD; just as it is with angels and early stage investors when they provide equity funding. It will typically take a start-up company 5-10 years to generate a liquidity event at which point the repayment to IRD can be factored into the price.

10 **Taxation of employee share schemes** – In 2015 the IRD embarked on work to reform the tax treatment of employee share schemes as the existing legislation is 50 years old, complex and out of date.[5] The Taxation (Annual Rates for 2017-18, Employment and Investment Income and Remedial Matters) Bill was introduced to Parliament in April 2017. It had its first reading in mid-2017 and was referred to the Finance and Expenditure Select Committee and passed into legislation at the end of March 2018.

11 Inland Revenue policy work on a deferral regime for tax on employee share schemes for start-up companies is ongoing. AANZ met with IRD a number of times during the course of the review and provided several submissions.[6] The key points made include:

- Tax treatment of start-ups, particularly high growth start-ups, merits differential attention;
- The use of employee share schemes in high growth start-ups is far less about remuneration than it is about creating alignment to drive up the value of the venture. The irrelevance of remuneration being the driver for the ESOP in a start-up is reflected in the illiquid nature of start-up equity and the prospect that the equity will be worthless as a high proportion of start-ups fail;
- ESOP regimes put in place very soon after a start-up's inception deserve to have any resultant (and rare) upside treated in the same way as the founder's equity as these early employees are more akin to investors, ie., the upside should be treated as held on capital account and not as taxable income;
- With reference to constant cash flow concerns in a start-up, any taxation event should only occur on exercise when the economic gain or loss is real;
- We support simplifying and clarifying the rules so there is less creative interpretation and uncertainty;
- We recognise defining a start-up is challenging in a tax policy context to ensure the right incentives for value creation and economic outcomes, but it is not impossible.
- Some countries have specific exemptions and lower tax rates for ESOPs issued by start-ups (eg Canada, Australia, UK) but these countries also have capital gains regimes. See our comment below on the tax treatment of capital gains in a start-up investment context.

What we would like

12 The AANZ recognises the importance and rationale for a "broad base, low rate" tax system and supports the IRD's focus on removing distortions to behaviour so that economically rational decisions can be

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[4] https://www.angelassociation.co.nz/wp-content/uploads/2017/03/KPMG-Angel-Association-of-NZ-RD-submission.pdf

[5] http://taxpolicy.ird.govt.nz/publications/2017-ris-areiirm-bill/employee-share-schemes

[6] https://www.angelassociation.co.nz/resources/reports/

made. We are very grateful for the constructive and collaborative working relationship we have with IRD officials. All those we have engaged with have worked to genuinely understand the unique set of circumstances and environment in which early stage, high growth company investors and founders work, and to understand the risks and challenges they face. While we appreciate the reticence and wariness surrounding the introduction of tax incentives we would like to set out some thinking on why some inroads might be made for high-growth start-ups.

13 **Incentives for investors** – The rationale for incentivising venture capital and angel investment is that it offsets the extremely risky nature of these investments and at the same time supports the positive outcomes resulting from increasing the pipeline of deals and thereby improving the odds of success. This source of capital, in a venture's early stages of growth brings much needed expertise, experience and connections. So there are three points at which tax policy can incentivise investment in high growth start-ups. On the:

- initial investment;
- receipt of investment income – although investment income (dividends etc) is uncommon in start-ups;
- disposal of the investment – this might be negative (when the start-up fails) or positive (typically when a trade sale or IPO occurs).

14 As the EU study referenced above points out, the literature on the relative merits of tax incentives at each of these stages is sparse.

15 Tax incentives or tax relief granted on initial investment has two key policy design implications:

- It addresses investor risk aversion by in effect subsidising the cost of the investment, which increases the amount the value of the investment would have to fall by before a loss is made;
- It rewards new capital, rather than creating windfall gains for existing investors.

16 Granting tax relief on initial investment is less likely to generate alignment of interests between the investor and investee. In the absence of tax relief on disposal of the investment investors are less incentivised to support the development and growth of the investee firm. This reduces the economic benefits the incentive should deliver, such as growth, job creation and productive innovation with the consequent spill-over effects to the wider economy.

17 The provision of loss relief on disposal compensates the investor for the excessive downside risk associated with investing in start-ups. Loss relief also incentivises 'fast failure' and thereby liberates capital and capability for those ventures which are performing. This is about shifting the incentive from the business to the investor where the insight and value/risk trade-off is more credible and powerful.

18 There is then the issue of qualifying criteria for the tax relief. This can be done via the:

- Business: the recipient of investment can be targeted in terms of age, size and sector;
- Investor: the investor can be targeted in terms of wealth or connection with the recipient of investment (eg use of Financial Markets Conduct Act exemptions);
- Investment: the investment can be targeted in terms of size, investment through venture capital funds or angel network (eg use of NZVIF accredited partners); and
- Duration: the minimum length of time qualifying investments must be held in order to attract tax relief.

19 In assessing tax incentive regimes in 36 countries against clarity of scope, qualifying criteria and administrative ease the 2017 EU Commission study found the United Kingdom's Enterprise Investment Scheme (EIS) was the best. Evidence collected in assessments of the EIS found the scheme had a positive impact on a range of measures including labour productivity in investee companies. [7] The effect was greatest for smaller companies regardless of age.

20 **Same business test for carrying tax losses forward** - Tax losses incurred by a company have value to the extent they are able to be carried forward and offset against future income. Forfeiting these losses has a cost to the company. Innovative companies, early-stage companies and rapidly growing companies are more likely than other companies to incur tax losses at certain stages in their life.

21 Current New Zealand law requires a minimum 49% continuity of ownership for a company to carry forward tax losses. Changes of ownership, including as a result of capital injections by new investors to fund growth and development can result in forfeiture of tax losses. Other countries supplement their continuity of ownership test with a "same business" test which allows a company to carry forward tax losses despite changes of ownership, provided the company carries on the same type of business.

[7] http://openaccess.city.ac.uk/16270/1/from_funding_gaps_to_thin_markets.pdf

22 The absence of a same business test in New Zealand results in punitive tax outcomes, distorts decision-making and disincentivises innovation, growth and risk-taking. Introducing a same business test would remove a barrier to growth and innovation in New Zealand, bring New Zealand law into line with international norms and most likely be fiscally positive.

23 AANZ is working with Business New Zealand, NZVCA, the Corporate Tax Payers Group and Bell Gully to lobby Government to amend the legislation to bring New Zealand into line with current international practice and recently met with new Revenue Minister, Stuart Nash. He was receptive to the points made and the next step is to bring other relevant Ministers up to speed.

24 **Simple R&D tax credit regime** – While not specifically targeted at angel investors, an R&D tax credit regime would be beneficial to high growth start-ups. Given the pressure on start-up resources (both labour and capital) any new regime needs to be clear in its scope, simple to access, simple to apply for and simple to receive.

25 A 2014 EU Commission study examined over 80 schemes in 31 countries.[8] The majority of tax incentives apply to corporate income taxes. In some countries, the benefit is also set against social contributions and/or wage taxes. R&D tax credits are the most popular type of R&D tax incentive, followed by enhanced allowances for expenditure on R&D and accelerated depreciation. R&D tax incentives applied to the total R&D expenditure (known as volume-based schemes) are more common than tax benefits only applied to the increment of R&D expenditure (incremental schemes).

26 Many jurisdictions target the scale of any tax credit to the size of the company. The AANZ also supports targeting to offer more generous tax advantages to high growth start-ups. This limits the cost to government and sends a clear signal about the value of such ventures. We would like to see a straight forward, online application procedure and a one-stop agency for approval of R&D tax credits.

Capital gains tax

27 Given the risk profile of high growth start-ups, investment in the equity of these companies generally makes up a very small component (5-10%) of any individual angel's investment portfolio or net wealth. With a portfolio of 20 ventures, 30% of angels will experience a negative internal rate of return. To put it another way, 90% of the returns from an angel venture portfolio come from just 10% of the ventures.

28 A common criticism of the lack of a capital gains tax in New Zealand is that it distorts and diminishes the income tax base. The current statutory definition of income bears little relation to actual or comprehensive income. So for example there is no attempt in the Income Tax Act 2007 to measure the change in an individual's net wealth or level of consumption over the taxable period. Instead the Act taxes income by reference to the concept of "ordinary income". It defines specific forms of ordinary income, which may be either revenue or capital in nature. [9] Very broadly, income from revenue is taxed, income from capital is not.

29 While there is no capital gains tax in New Zealand there is a distinct lack of clarity for angel investors regarding the tax treatment of their investment in high growth start-ups. Individuals who are angel investors in the true sense of the definition, are not "in the business" or generating income from angel investment given the illiquidity of start-up shares, the high failure rate of these ventures and the small component these investments form of their net wealth. Early stage venture capital fund managers, despite the fact they are in the same boat as individual angels when it comes to the paucity of returns on a deal by deal basis, for the sake of certainty tend to operate on revenue account.

30 To clarify the concept of ordinary income, the Income Act contains extensive definitions of most types of income falling within the concept of ordinary income (i.e. on revenue account). An obvious example is income derived from employment (e.g. salary and wages), which is clearly revenue and taxable as ordinary income. A less obvious example is share gains. Whether or not realised share gains are taxable depends on whether the seller of the share held that share on capital or revenue account. This lack of clarity impacts on the extensive range and confusion around the taxation of employee share ownership schemes, particularly in high growth start-ups.

31 Determining whether shares are held on revenue or capital account turns on whether the dominant purpose of acquisition was for resale. Angel investors freely acknowledge that to be sustainable, angel investment has to generate returns. But they are also motivated by a wider purpose; to grow their local economy, to 'give back' and to be involved with cutting edge technology and business development.

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[8] https://ec.europa.eu/futurium/en/system/files/ged/28-taxud-study_on_rnd_tax_incentives_-_2014.pdf

[9] https://www.victoria.ac.nz/sacl/centres-and-institutes/cagtr/twg/publications/3-taxation-of-capital-gains-ird_treasury.pdf

32 A well-designed capital gains tax policy, which includes property, together with a carefully defined and described high growth start-up ecosystem and its ventures, would see resources channelled more efficiently and purposefully to support the success of these high risk, but high impact ventures. A capital gains tax, and a corresponding offset for capital losses, would allow early stage investors some respite from the inevitable failure of early stage investments.

Conclusion

33 Generating returns from inspirational high-growth, start-up companies is critical for New Zealand. These companies are our future economic powerhouses. But investing in them is an extremely high-risk endeavour and is not for the faint hearted. On a deal-by-deal basis, an investor in a high growth start-up is more likely to lose their money than not.

34 Raising enough high growth start-ups to generate a unicorn worth a billion dollars and generating thousands of jobs takes a whole country. Given the risk/return profile there is therefore a compelling rationale for differential treatment and support for early stage investors – be they individuals or early stage venture funds.

35 Angel Association New Zealand and our members want to generate an impact that goes beyond the financial return on investment to see a thriving New Zealand and New Zealanders making the world a better place. We are therefore very willing to dedicate time and resources to assist with any work to advance the thinking for a tax framework supporting these outcomes.

Suse Reynolds
AANZ Executive Director
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Appendix
Explanation of early stage investment in New Zealand

As a formally recognized endeavor in New Zealand, early stage or start-up investment in high-growth ventures is about a decade old. The catchall term is “angel investment”. Strictly speaking, an angel is an individual who invests his or her own money but the term ‘angel investment’ is also used to refer to more broadly supported early stage funds.

The Angel Association New Zealand (AANZ) was incorporated in 2008 to promote the growth of angel investment. Today there are 12 angel clubs or networks and half a dozen early stage or angel funds in New Zealand. The oldest and most established clubs are based in Auckland, Tauranga, Wellington and Nelson. Half a dozen new clubs have been established in recent years and two more are in formation. About 650 angels belong to the AANZ member networks. AANZ’s members also include investor-led tech incubators and two of the most prominent equity crowdfunding platforms in New Zealand, Snowball Effect and Equitise.

The New Zealand Venture Investment Fund (NZVIF) established the Seed Co-Investment Fund (SCIF) in 2006 to catalyse a formal early stage investment sector. This $50m fund was set up to co-invest alongside accredited clubs and funds on a dollar-for-dollar basis as a passive investor, up to a maximum of $750,000 in any one deal. To date the fund has backed over 150 ventures and, together with its co-investment partners, invested over $500m. The median age of a SCIF portfolio company is just 3 years old and to date only 21 companies have had a positive exit generating an IRR of just over 9%. More active management and a more flexible mandate for management of this largely nascent portfolio is planned to lift this result.

Annual investment in high growth start-ups has exceeded $50m for the last four years and grown by an average in excess of $5m per annum to reach $86m in 2017. Only a quarter of this capital is being invested in new deals with the bulk being directed to follow on funding for existing ventures. This is a sign of a maturing market as investors double down on their higher performing portfolio companies.

New Zealand angels have a preference for software (40%) and life sciences (15%) companies. A typical New Zealand angel invests between $5,000-30,000 per deal; 20% of our community are leading deals and sitting on angel-backed company boards; the average portfolio size is 13 companies and angels typically commit 29 days a year to mentoring and supporting the ventures they have backed. Angel investors must be accredited investors as defined by the Financial Markets Conduct Act 2014. In terms of deal size and company valuations, on average a New Zealand angel round is circa $700,000 and angels are backing companies valued at around $1.2m. About a fifth of our companies have received offshore investment.

A portfolio approach to angel investment is vital. The right sized portfolio, managed by focused skilled people, together with the right timing will deliver an IRR of 20-40% or 10-30x their money back to an angel investor. Not to be lightly dismissed, angels are also motivated by the belief their investment generates social and economic returns; the belief they are building and inspiring their community’s future wealth generators and jobs.

The aim is to create value as quickly as possible and set these ventures on a path making them irresistible to potential acquirers or public equity markets. The value is in the demonstration and proof of product/market fit. A deep understanding of capital strategy is required as it impacts directly on the ability to scale value quickly and generate the necessary returns. A high growth capital strategy is typically agile and deploys capital super efficiently.

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http://www.ird.govt.nz/research-development/overview/what-is-rdltc/
https://www2.deloitte.com/nz/en/pages/tax-alerts/articles/r-d-tax-credits-reflections-from-nz-and-australia.html
NZ scheme explained for R&D loss tax credit… from the IRD and Deloitte

https://www.pwc.com/gx/en/tax/pdf/pwc-global-r-and-d-brochure-april-2017.pdf
a really useful summary of all the tax regimes used around the world to incentivise R&D

https://assets.kpmg.com/content/dam/kpmg/xx/pdf/2017/08/emea-rd-incentives-guide-web-08012017.pdf
same thing but from KPMG

http://www.ey.com/nz/en/services/tax/ey-tax-watch-november-2017-research-and-development-tax-credit-to-be-reinstated
EY explain the difference between the tax loss credit and Labour's plans

https://ec.europa.eu/taxation_customs/sites/taxation/files/final_report_2017_taxud_venture-capital_business-angels.pdf
A really terrific explanation of a range of tax incentives (including EU and a number of OECD countries) and includes a series of tables comparing jurisdictions

https://www.ato.gov.au/Business/Tax-incentives-for-innovation/In-detail/Tax-incentives-for-early-stage-investors/#Calculatingtheearlystageinvestortaxoffse
a good explanation of the Auzzie tax incentives for angel investments… essentially 20% credit up to a maximum rebate of $AU200,000

http://openaccess.city.ac.uk/16270/1/from_funding_gaps_to_thin_markets.pdf
the most often quoted 2009 study of the impact of the UK's EIS and SEIS tax relief schemes for investment into start-ups

https://www.victoria.ac.nz/sacl/centres-and-institutes/cagtr/twg/publications/3-taxation-of-capital-gains-ird_treasury.pdf
a neat summary of the issues and implications of a capital gains tax for NZ which also explores different CGT regimes