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AUSTRALIA + NEW ZEALAND

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## **WEEKLY COMMENT: FRIDAY 17 JULY 2020**

1. The *COVID-19 Response (Taxation and Other Regulatory Urgent Measures) Act 2020* (the “second COVID-19 Tax Amending Act”), which received the Royal assent on 30 April 2020, contains a number of amendments to various Acts. The main income tax amendment is the provision of a new election to carry back tax losses incurred in 2019-20 and 2020-21, including a new anti-avoidance rule and a change to the provisional tax estimation rules.
2. This week I look at the new rules as they apply to non-company taxpayers and company taxpayers that are not in a group of companies. Next week, I will look at the rules as they apply to companies in a wholly-owned group and an ordinary group, and the new anti-avoidance rules applying to arrangements to allow losses to be carried back.

### **Election to carry back 2019-20 and 2020-21 tax losses**

3. The amendments allowing a tax loss to be carried back apply from 15 April 2020. Inland Revenue has published an article on the loss carry back rules in *Public Act 2020 No 8 and No 10* (“the Public Act 2020 Article”) which is to be included in the August 2020 *Tax Information Bulletin* when it is issued. Inland Revenue has stated that:

“The loss carry-back measure in the Act is intended as a temporary measure to provide fast cash flow for businesses in loss during the period affected by COVID-19. The measure enables tax refunds for a profit year to be paid before the loss year has finished by enabling taxpayers to estimate the loss for the year and transfer it back to the profit year.

The measure provides for a one-year carry-back. The Government has indicated its intention to develop a permanent loss carry-back mechanism to apply from the 2021–22 tax year. The longer-term regime may be more traditional, such as not allowing a refund before the loss has been established and may have more integrity measures to cover some technical risks. The longer-term regime may provide for a one-year or two-year loss carry-back.

Almost all types of taxpayers – companies, trusts and individuals – are eligible to carry back losses. ...

Taxpayers will generally access this provision by changing their estimated provisional tax. The deadline for re-estimating provisional tax has been extended from the final instalment date until the date the tax return is due or filed, whichever is the earlier.

Taxpayers are able to choose whether to use this facility.”

4. A new s. IZ 8 has been inserted into the *Income Tax Act 2007*. Section IZ 8(1) allows a person who has “initial taxable income” in the 2018–19 or 2019–20 income year and a “net loss” in the following income year to choose to reduce the “initial taxable income” by the “available net loss”, which, in this context, refers to the “net loss” carried back from the following year.
5. The net loss in Year 2 is reduced by the amount carried back and used in Year 1.

### **The offset years**

6. The rule applies to 2 income years beginning with the 2018-19 or the 2019-20 income years, referred to as the “offset years”. There are two sets of offset years:
  - (a) The 2018-19 and 2019-20 income years; and
  - (b) The 2019-20 and 2020-21 income years.
7. In each set of offset years, the first of the 2 years is referred to as the “taxable income year” and the second of the 2 years is referred to as the “net loss year”. It should be obvious, but it is still worth noting that:
  - (a) If there is taxable income after deducting any donations tax credit in the 2019-20 income year, these temporary loss carry back rules cannot apply to the 2 income years beginning with the 2018-19 income year – i.e. they cannot apply to the 2018-19 and 2019-20 income years;
  - (b) If there will be taxable income after deducting any donations tax credit in the 2020-21 income year, these temporary loss carry back rules cannot apply to the 2 income years beginning with the 2019-20 income year – i.e. they cannot apply to the 2019-20 and 2020-21 income years;
  - (c) If there is or will be taxable income after deducting any donations tax credit in both the 2019-20 and 2020-21 income years, these temporary loss carry back rules cannot apply at all.

### **Net income, net loss, and initial taxable income**

8. Three important definitions that are worth reviewing at this point are the definitions of the terms “net income”, “net loss” and “initial taxable income”:
  - (a) “Net income” for a year, as defined in s. BC 4(1), is the amount by which gross income for the year exceeds the total deductions allocated to the year;
  - (b) “Net loss” for a year, as defined in s. BC 4(3), is the amount by which the total deductions allocated to the year exceed the gross income for the year; and
  - (c) “Initial taxable income” for a year, as given by s. IZ 8(2)(a) is the “net income” for the taxable income year after subtracting the total amount of charitable donations for which the person has a tax credit for the taxable year under subpart LD.
9. Inland Revenue has noted in the Public Act 2020 Article that “net income” and “initial taxable income” will be the same if there is no donations rebate for the income year.

10. A person who has an actual or expected net loss in either 2019-20 or 2020-21 income years may elect to carry back all, or an elected portion, of the net loss to the previous income year and offset it against the person's taxable income in the previous income year.

**A non-company carrying back a net loss**

11. A person that is not a company makes an election to carry a loss back:

(a) To the 2018-19 income year by:

- (i) Having a net loss in the 2019-20 income year, as required by s. IZ 8(5)(b); and
- (ii) Having initial taxable income in the 2018-19 income year of an amount at least equal to the elected amount of the net loss to be carried back, as required by s. IZ 8(5)(a); and
- (iii) Electing to include the elected amount, as required by s. IZ 8(5)(c), as an available tax loss in calculating taxable income for the 2018-19 income year, either by directly amending the 2018-19 tax return if within the time to do so, or by requesting an amended assessment under s. 113 of the Tax Administration Act 1994;
- (iv) Requesting the corresponding tax refund.

(b) To the 2019-20 income year by:

- (i) Having a net loss in the 2020-21 income year, as required by s. IZ 8(5)(b); and
- (ii) Having initial taxable income in the 2019-20 income year of an amount at least equal to the elected amount of the net loss to be carried back, as required by s. IZ 8(5)(a); and
- (iii) Re-estimating 2019-20 provisional tax (the deadline to do this has been extended from the final instalment date to the date the tax return is filed, or, if earlier, the due date for filing the tax return); and
- (iv) Requesting the corresponding refund of provisional tax; or
- (v) Electing to include the elected amount, as required by s. IZ 8(5)(c), as an available tax loss in calculating taxable income for the 2020-21 income year in the tax return for the 2020-21 income year and requesting the refund in the tax return.

12. Inland Revenue has pointed out in the Public Act 2020 Article that the definition of "initial taxable income" prevents a non-company taxpayer from carrying a loss back to the extent that charitable donations will exceed the revised taxable income. Charitable donations are only creditable up to the taxable income of a person.

13. Example 10 in the Public Act 2020 Article concerns a business person who donates \$3,000 of their \$5,000 income to charity in Year 1, and makes a loss of \$5,000 in Year 2. As a result of the charitable donation, the "initial taxable income" in Year 1 is \$5,000 reduced by \$3,000, which is \$2,000. Therefore, the maximum loss that can be carried back will be \$2,000.

14. Individuals who are taxed through the PAYE system and are subject to auto-calculation (qualifying individuals) do not have losses. However, Example 8 in the Public Act 2020 Article shows that such individuals can benefit if they operate a business that makes a loss in the second year:
- (a) In Year 1, the 2018-19 year, an individual earned only salary and wages of \$94,000 and paid tax of \$21,940;
  - (b) In Year 2, the 2019-20 year, the individual entered into a partnership and was allocated a partnership loss of \$40,000;
  - (c) The individual had limited other income of \$15,000, resulting in an overall loss in Year 2, the 2019-20 year, of \$25,000;
  - (d) The individual is eligible to carry the loss of \$25,000 back to Year 1, the 2018-19 year, reducing income from salary and wages in that year and resulting in a tax refund of \$8,220 after amending his 2018-19 tax return through myIR.
15. An individual with a residential rental loss would not be able to carry back the loss. This is shown by Example 9 in the Public Act 2020 Article. Under the rules for ring-fencing of residential property losses in subpart EL, residential rental deductions are capped at the amount of rental income received. Therefore, excess rental deductions must be carried forward and will not give rise to a tax loss that is able to be carried back.
16. Inland Revenue also notes in the Public Act 2020 Article that multi-rate PIEs (most unit trusts and KiwiSaver funds) may not carry back losses. Multi-rate PIEs (including KiwiSaver) have tax cash-out for losses so already benefit from immediate tax relief for losses.

### **Shareholding continuity for a company carrying back a net loss**

17. A person that is a company must satisfy shareholding continuity requirements in order to carry back and use a net loss. This is how these requirements apply:
- (a) The shareholding continuity requirements are the same as the shareholding continuity requirements in subpart IC for carrying forward and using a net loss;
  - (b) There must be a minimum continuous shareholding of at least 49% from the beginning of the taxable income year to the end of the net loss year;
  - (c) If the minimum continuous shareholding of 49% is for a lesser period, a net loss incurred within that lesser period may be carried back and offset against taxable income derived in that lesser period;
  - (d) The period in the offset years during which the shareholding continuity requirements are met is referred to as the “offset ownership period”;
  - (e) If the offset ownership period is less than the two complete offset years, s. IZ 8(12) requires the company to provide part-year financial statements to the Commissioner, as specified in sections IP 3 and IP 6 for carrying losses forward, to verify the net loss and the taxable income in the offset ownership period.

### **A company that is not in a group**

18. A company that is not in a group in the offset ownership period can carry back a net loss as follows:
- (a) The company's net loss that can be carried back cannot exceed the net loss incurred by the company in the "loss ownership period", being the part of the net loss year that is within the offset ownership period (if the "loss ownership period" covers the whole net loss year, the net loss for the year will be available to be carried back);
  - (b) The company's taxable income allowed to be offset is the smallest of:
    - (i) The company's taxable income for the taxable income year;
    - (ii) The company's net income for the "income ownership period", being the part of the taxable income year that is within the offset ownership period; and
    - (iii) The net loss in the loss ownership period that the company elects to carry back and treat as an available tax loss in the taxable income year;
  - (c) The company's net loss carried back cannot exceed the company's taxable income that is being offset.
19. The Public Act 2020 Article contains Example 2 on page 7 of a company with taxable income of \$268,000 for the 2019-20 year and an expected loss of \$341,000 for the 2020-21 year. On 1 May 2020, 52% of the company is sold to a third party. The tax loss for the period from 1 April to 30 April 2020 is \$160,000. The outcomes are that:
- (a) The company can carry the tax loss of \$160,000 incurred to 30 April back to the 2019-20 year and set it off the whole amount against the profit for that year, since the 2019-20 taxable income exceeded \$160,000;
  - (b) The loss incurred after 30 April 2020 cannot be carried back because the required shareholding continuity of 49% was breached on 1 May 2020;
  - (c) The remaining 2020-21 tax loss of \$181,000 can be carried forward and used in 2021-22;
  - (d) The company will need to meet the requirements to use a part year loss such as preparing part year accounts to the date of the breach in continuity.

### **Verification of the net loss carried back**

20. The carry back of a net loss is not effective until the person with the net loss to be carried back to the taxable income year:
- (a) Files a tax return for the taxable income year including a figure (or an updated figure) for the elected amount of the net loss carried back; or
  - (b) Makes a request to the Commissioner to amend an assessment, under s. 113 of the *Tax Administration Act 1994*, for the taxable income year to include a figure (or an updated figure) for the elected amount of the net loss carried back.
21. If the elected amount of the net loss used in the taxable income year exceeds the amount permitted under s. IZ 8, a request to amend the assessment for the taxable income year

must be made, under s. IZ 8(11), to make the elected amount comply with the requirements of s. IZ 8.

22. It is noted on page 15 of the Public Act 2020 Article that if the loss carry-back is overestimated, resulting in tax to be paid later, standard use-of-money interest would apply in the normal way.
23. In addition, where use-of-money interest applies because of an overestimate of the loss carry-back, the taxpayer cannot use the COVID-19 remission of interest provisions in s. 183ABAB of the *Tax Administration Act 1994*, discussed in Weekly Comment 3 July 2020.

### **Claiming a tax refund and imputation credit account implications**

24. It is noted on page 15 of the Public Act 2020 Article that to obtain a refund of income tax (i.e. provisional tax or terminal tax), an imputation credit account company must have an imputation credit account credit balance of at least the amount of the refund at the end of the most recently ended imputation year (meaning, that if a refund is requested for the 2018–19 year, it will be necessary to file an imputation return up to 31 March 2020).
25. Alternatively it can complete an interim imputation return up to the date of the refund request. Example 7 in the Public Act 2020 Article shows that the balance in the interim ICA could restrict the refund available, meaning that the remainder of the tax refund would have to be held in the company's income tax account to use towards other income tax debts or future income tax payments.

### **Other concessions**

26. Section RM 10(4) has been amended so if the taxpayer owes a debt on other tax types, Inland Revenue will not apply any of the refund arising from the loss carry-back to satisfy tax debts.
27. A taxpayer estimating provisional tax to take advantage of the loss carry back scheme will not take provisional tax associates out of the interest concession rules in s. 120KBB of the *Tax Administration Act 1994*.

### **Shareholder employees**

28. Inland Revenue has noted in the Public Act 2020 Article that although only the company would undertake a loss carry-back, practically within the system both the shareholder-employee and the company would have to opt-in for a loss carry back to enable provisional tax paid by a shareholder to be refunded.
29. Inland Revenue also notes that while it may be possible to equalise shareholder salaries between years by declaring a salary in the loss year and creating a loss to carry back, the anti-avoidance provisions in sections BG 1 or GB 25 would apply to such payments and an abusive tax position penalty of 100% could also apply.



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