

Regulatory Impact Statement

Remission income, tax losses and insolvent individuals

Agency Disclosure Statement

This Regulatory Impact Statement has been prepared by Inland Revenue.

It provides an analysis of options to address inconsistencies in the taxation law relating to the carry-forward of tax losses and the fresh-start principle of insolvency law.

The options are considered in the light of the objectives of:

- neutrality of the tax system in relation to investment decisions;
- the efficiency of the tax system; and
- the objectives of insolvency law.

For the purpose of our analysis, we assumed that the tax system should complement the objectives of insolvency law in relation to the fresh-start principle.

The estimate of nil fiscal impact is based on current outcomes in practice. Published data indicates about 3,000 individuals annually are subject to insolvency procedures and obtain relief from debts under the fresh-start principle of insolvency law. Because of data limitations in identifying all taxpayers who may benefit from the fresh-start principle, it is not possible to determine the number of insolvent individuals who have carried-forward tax losses. However, as the objective of the policy proposals is for the tax system to better support the objectives of insolvency law, this limitation has not impacted on the analysis or conclusions.

The policy proposals were provided to a targeted audience, but no material matters were raised in feedback.

None of the policy options considered have environmental or cultural impacts, and nor were there any significant constraints, caveats and uncertainties concerning the regulatory impact analysis, other than the data limitations noted above.

None of the policy options considered would restrict market competition, reduce the incentives for business to innovate and invest, unduly impair private property rights, or override fundamental principles of common law.

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STATUS QUO AND PROBLEM DEFINITION

Current regulatory environment

1. Under long-standing policy, a person is able to carry forward unused tax losses from year to year, to offset against net income in a future tax year. However, this ability to carry forward tax losses has always been contingent on the debtor fully satisfying his or her liabilities for expenses incurred that have been taken into account in calculating past tax losses.
2. Allowing a person to carry forward tax losses is based on the assumption that a person would continue in business and make sufficient profits to absorb earlier losses. This is consistent with key policy objectives for the tax loss carry-forward rules, which is to encourage entrepreneurial risk-taking and that Governments share in the rewards of that business through taxes.
3. If a person is unable to continue in business and be sufficiently profitable to absorb earlier tax losses, it is possible for that person to become insolvent and be unable to satisfy debt obligations as they fall due. If an insolvent person is unable to satisfy those debt obligations, they may obtain relief from their debts by being declared bankrupt or by entering into arrangements under alternatives to bankruptcy, such as occurs on completion of the “no-asset procedure” under the Insolvency Act 2006, or under a deed of compromise with creditors.
4. In general, the intervention of insolvency law in contract law is intended to protect the honest, but unfortunate debtor from his or her creditors, through discharge from debts after a period to enable a fresh start (“the fresh-start principle”).
5. However, the fresh-start principle is not solely concerned with “resetting” the insolvent person’s financial liabilities to zero. It also involves the insolvent individual:
 - surrendering his or her capital for equitable distribution among creditors (subject to minimal retentions for family maintenance); and
 - being able to resume economic activity, free of the burden of past debt (other than certain debts, such as child support debt), with only a minimal level of personal assets.
6. The basis of the fresh-start principle is that the insolvent person surrenders rights to property they own in exchange for the subsequent cancellation of debts on discharge from bankruptcy. The purpose of this trade-off is to encourage insolvent individuals to again become productive, benefitting both themselves, and society as a whole.

Current law and practice: income tax

7. Under current income tax law, a person is required to satisfy his or her income tax obligations in relation to income derived. Normally, it is clear that the person who derives the income is also required to satisfy those income tax obligations, including filing returns of income.
8. On being declared bankrupt, the person receives a new Inland Revenue number. This practice is to enable Inland Revenue and the bankrupt to distinguish between income tax obligations before and during bankruptcy.

9. There are three sets of income tax rules relating to carried-forward tax losses of a person who is declared bankrupt:

- First, tax losses of an insolvent individual may be carried forward into the period of bankruptcy and applied against income derived during bankruptcy. This may result in a refund of tax, which is part of the bankrupt estate. Inland Revenue is required to pay that refund to the Official Assignee who would include this in distributions to creditors. Under current tax and insolvency law, this is the only means by which creditors receive the benefit of the bankrupt's carried forward tax losses.
- Second, the Commissioner of Inland Revenue is obliged to write off tax debt that is unrecoverable from the bankrupt estate. If tax debt of a bankrupt is written off, any carried forward tax losses are correspondingly reduced.
- Third, on discharge from bankruptcy, most of the bankrupt's outstanding debts are cancelled (there are some exceptions to this principle, in particular, child support debt) and remission income may arise to the extent of the person's carried-forward tax losses.

10. Under remission income rules in the Income Tax Act 2007, if a bankrupt has previously carried on a business, some of the debt cancelled on discharge from bankruptcy may be recovered as remission income. The intended effect of these remission income rules is to reduce the amount of carried forward tax losses.

11. These remission income rules apply on discharge from bankruptcy if expenses incurred by the bankrupt are included in the calculation of past tax losses. The operation of the remission income rules is consistent with the long standing policy that the carry-forward of tax losses is contingent on satisfying debts incurred relating to deductions included in past tax losses.

12. After the application of these rules, if a discharged bankrupt has a carried forward tax loss remaining, under current law, any remaining tax loss is then able to be used to offset against his or her future income.

Current law and practice: the insolvent individual and the Official Assignee

13. The Official Assignee is responsible for administering the application of insolvency law for individuals. Under insolvency law, there are two main procedures that can result in an insolvent person being released from all debts under the Insolvency Act 2006:

- bankruptcy; and
- the no-asset procedure.

14. On being declared bankrupt, all assets of the bankrupt are vested in the Official Assignee by operation of law, and become property of the bankrupt's estate. During bankruptcy, any property received by the bankrupt is also vested by operation of law in the Official Assignee and becomes property of the bankrupt estate.

15. Under insolvency law, property vesting in the Official Assignee includes income derived by the bankrupt during bankruptcy. This income is usually earned from personal exertion during bankruptcy and usually consists of salary or wages. However, this rule of vesting is subject to the bankrupt being permitted to retain sufficient income and certain assets to a level that is necessary for family maintenance. In practice, the Official Assignee generally permits a bankrupt to retain salary or wages earned, but the bankrupt can be asked to contribute to the bankrupt estate from after-tax income. In addition, all tax refunds arising during the period of bankruptcy belong to the Official Assignee.

16. As a matter of practice, the Official Assignee does not file returns of income on behalf of the bankrupt or for the bankrupt's estate. We understand that this practice is based on the view that the Official Assignee is not an agent for the bankrupt and that the administration of the bankrupt estate is covered by the exemption from income tax for public authorities in the Income Tax Act 2007.

17. The no-asset procedure is an alternative to bankruptcy for insolvent individuals with low levels of provable debt (up to \$40,000) and no realisable assets (other than minimal levels of assets for family maintenance and tools of trade). This procedure is administered by the Official Assignee, and the insolvent individual must obtain approval to enter the procedure. Provided the individual complies with requirements relating to spending and credit during the term of the no-asset procedure, on completing the term of the no-asset procedure (usually one year), those provable debts are wiped. This procedure does not apply to student loan or child support debt.

The problems

18. In general, where the tax system interfaces with non-tax policy objectives, the tax system seeks to give outcomes that are complementary to the non-tax policy objectives.

19. However, the policy and operational objectives for current tax rules for insolvent individuals are not well-aligned with the policy objectives of insolvency law, and in particular the fresh-start principle. This gives rise to a number of technical and administrative issues, as follows:

- inconsistent treatment of tax losses carried-forward into bankruptcy;
- inconsistency with the policy for carrying-forward tax losses being contingent on satisfying expenses incurred that have been included in past tax losses;
- some tax deduction and timing rules do not give neutral outcomes when a person is declared bankrupt; and
- the carrying forward of tax losses on discharge from bankruptcy is potentially non-neutral in relation to both investment decisions and the treatment of discharged bankrupts;
- the insolvency law rule that treats income derived by the bankrupt as property of the Official Assignee results in uncertainty over who is responsible for filing returns of income for the bankrupt; and

- business records of a person declared bankrupt are to be given to the Official Assignee and not retained by the taxpayer, which is inconsistent with the requirements of taxation law.

20. If the value of carried-forward tax losses is significant and those tax losses are not fully realised during bankruptcy (through tax refunds), a discharged bankrupt has access to a valuable tax asset. Under income tax law, a tax loss that is carried-forward after discharge from bankruptcy is a tax asset that benefits the taxpayer in future years by reducing tax on income derived in the future. This retention of a potentially valuable tax asset beyond discharge from bankruptcy is inconsistent with the fresh-start principle which holds that the cancellation of debts on discharge from bankruptcy is in exchange for the insolvent debtor surrendering assets for the benefit of creditors.

21. In practice, carried-forward tax losses generally result from past expenses, many of which are funded by debt. Allowing tax losses to be carried forward, if those losses are funded by debts that cancelled on discharge from bankruptcy, would be inconsistent with the long-standing policy that tax losses should only be able to be carried forward if the taxpayer fully satisfies debts for expenses incurred relating to past tax losses.

22. On being declared bankrupt, all property of the bankrupt vests in the Official Assignee. Some timing, valuation and deduction rules apply on disposals of tax-base property, which would include a disposal by way of assets vested in the Official Assignee. The technical application of these rules can result in losses and gains being included in the bankrupt's taxable income despite those losses and gains on vesting having no connection with the past business of the bankrupt. It is not intended that being declared bankrupt should result in such non-neutral tax outcomes. Such an outcome would be inconsistent with the policy objectives of:

- income tax law in relation to gains or losses arising from disposals of tax-base property; and
- insolvency law, which does not intend deductions for losses or income to arise on a person being declared bankrupt.

23. The ability for carried-forward tax losses to survive bankruptcy may also influence investment decisions. Assuming all other things to be equal, as tax losses currently survive bankruptcy, the use of the sole trader business structure would likely be preferred over a company structure because tax losses of a company are extinguished on liquidation.

24. This non-neutral outcome arises because the remission income rules that apply on discharge from bankruptcy do not apply to all forms of debt. For example it does not apply to a fixed term loan (a financial arrangement) used to finance the purchase of trading assets but does apply to trade debt. Therefore it is likely that a taxpayer would prefer to finance the business trading activity with a debt that would not be subject to the remission income rules (which would mean that carried-forward tax losses are not reduced on discharge from bankruptcy). This is illustrated in the example set out in paragraph 36.

25. A horizontal equity concern is that the tax system currently allows the future tax benefit of carried-forward tax losses (an asset) to be retained following discharge from bankruptcy. This means that the discharged bankrupt with carried-forward tax losses has an advantage compared to a discharged bankrupt who does not have carried forward tax losses. This is a non-neutral outcome arising from current income tax law.

26. Under income tax law, it is normally clear who has derived income. However, under insolvency law, income derived by a bankrupt during the period of bankruptcy is technically property of the Official Assignee, but subject to the bankrupt being able to retain a sufficient amount of that income for family maintenance purposes. This gives rise to uncertainty about who has derived that income. The main administrative problem arising is that it is unclear who is responsible for the income tax obligations for income derived by a bankrupt during the period of bankruptcy.

27. Another administrative and compliance issue arises due to insolvency law requiring business records of a bankrupt to be vested in the Official Assignee. The Official Assignee's practice is not to file returns of income on behalf of the bankrupt individual as the Official Assignee is not the agent for the bankrupt, but serves to administer the bankrupt's estate on behalf of the creditors and not for the benefit of the bankrupt. Consequently, neither the bankrupt nor Inland Revenue have ready access to the necessary information to determine whether a carried forward tax loss exists either on being declared bankrupt or on being discharged from bankruptcy.

28. Published data indicates that in each year about 3,000 individuals are subject to insolvency procedures in recent times and obtain relief from debts under the fresh-start principle of insolvency law. Because of data limitations in identifying all taxpayers who may benefit from the fresh-start principle, it is not possible to determine the number of insolvent individuals who have carried-forward tax losses. However, as the objective of the policy proposals is for the tax system to better support the objectives of insolvency law, this limitation has not impacted on the analysis or conclusions.

OBJECTIVES OF THE POLICY REVIEW

29. The main objective of this review is to ensure that tax policy outcomes support the objectives of insolvency law. Specifically, the review considers, and to what extent, carried-forward tax losses of an insolvent person should be cancelled –

- on discharge from bankruptcy or completion of the no-asset procedure (Insolvency Act 2006); and
- on remission of debt occurring within alternatives to bankruptcy under statutory or common law.

30. The options considered in this RIS are evaluated against the following criteria:

- a. maintaining the coherency of the tax system, including horizontal equity;
- b. consistency with the objectives of insolvency law
- c. minimising tax and compliance costs for taxpayers;
- d. minimising administration costs for the Official Assignee; and
- e. minimising administration costs for Inland Revenue.

31. The review is not intended to alter the general tax treatment for partial remission of debt under statutory or common law alternatives to bankruptcy.

32. We also note that trade-offs will inevitably be made across the various criteria. For example, clarifying that the bankrupt is responsible for satisfying income tax obligations for income derived during bankruptcy meets criterion (a) but may result in an increase in compliance costs for the taxpayer (criterion (c)).

REGULATORY IMPACT ANALYSIS

33. Three options, including the status quo are considered in this RIS for addressing the problems. The options are as follows:

- Option 1 – An insolvent individual who becomes bankrupt continues to apply the current remission income rules. These rules apply if some, or all, debt is remitted or cancelled under any procedure of insolvency law, but do not apply to all types of debt. Tax losses may continue to be carried-forward on discharge from bankruptcy.
- Option 2 – An insolvent individual who is released from all debt under any procedure of insolvency law will have their carried-forward tax losses cancelled. The remission income rules that apply on discharge from bankruptcy would no longer apply.
- Option 3 – An insolvent individual who has been released from all debt under any procedure of insolvency law will have their carried-forward tax losses cancelled, but only to the extent of business debts that have been cancelled. The remission income rules that apply on discharge from bankruptcy would no longer apply.

Analysis of options

Option 1: status quo

34. Under option 1, the current law and practice would remain unaltered.

Maintaining the coherency of the tax system, including horizontal equity

35. Option 1 permits a bankrupt to carry tax losses forward after being discharged from bankruptcy, at which time debts of the bankrupt are released and the bankrupt is given a fresh start.

36. Option 1 is inconsistent with the objective that the tax system should be neutral in relation to investment decisions. In particular, the loss carry-forward rules relating to insolvent persons provides an incentive for taxpayers to prefer:

- a. the sole trader business structure over a company business structure (this is because under current tax law, carried-forward tax losses survive bankruptcy of an individual but do not survive liquidation of a company; and

- b. funding their business with either personal savings, or debt to which the remission income rules do not apply. This is illustrated in the following example.

On discharge from bankruptcy, assume a bankrupt has a carried-forward tax loss of \$500. Under current tax law, the amount of tax losses that could be carried forward after discharge from bankruptcy would differ, according to the type of business funding adopted, as follows:

<i>Business funded by</i>	<i>Amount of business funding</i>	<i>Tax loss to carry-forward</i>
• <i>personal savings</i>	<i>\$500</i>	<i>\$500</i>
• <i>debt subject to remission income rules</i>	<i>\$500</i>	<i>\$0</i>
• <i>debt not subject to remission income rules</i>	<i>\$500</i>	<i>\$500</i>
• <i>debt, 60% of which is subject to remission income rules</i>	<i>\$500</i>	<i>\$200</i>

37. Option 1 is inconsistent with the long standing tax policy for the carry-forward of tax losses that the carry forward of tax losses is contingent on satisfying debts for expenses incurred that have been included in past tax losses.

38. The technical ability to carry forward tax losses beyond discharge from bankruptcy results in non-neutral tax treatment for discharged bankrupts with tax losses as compared to discharged bankrupts who do not have tax losses. This is inconsistent with the principle of horizontal equity and consequently impacts on the coherency of the tax system.

39. Under the status quo, it is still possible for a range of timing, valuation, and deduction rules to apply on a person being declared bankrupt. Some market value rules may result in the bankrupt being required to include, in calculating their taxable income, the value of property vested in the Official Assignee. This results in a non-neutral tax treatment for the bankrupt solely from the process of bankruptcy.

Consistency with the objectives of insolvency law

40. Continuing with the status quo, which allows tax losses to be carried forward following discharge from bankruptcy, would result in income tax law continuing to be inconsistent with the fresh-start principle and provide non-neutral outcomes as between discharged bankrupts. These problems are set out in paragraph 19 of this RIS.

Minimising tax and compliance costs for taxpayers

41. Currently taxpayers incur the cost of engaging an accountant to determine if tax losses exist on being declared bankrupt or on discharge from bankruptcy. It is not possible to determine the scale of these costs due to data limitations.

42. Outcomes from Inland Revenue's administration of insolvents indicate that very few taxpayers have tax losses on discharge from bankruptcy and that often there are insufficient business records available to establish whether tax losses exist. No material change is expected in tax and compliance costs for taxpayers under option 1.

Minimising administration costs for the Official Assignee

43. Currently, the Official Assignee's administration costs for insolvent individuals relate to insolvency procedures under the Insolvency Act. Due to data limitations, the scale of these costs is not able to be determined. No material change is expected in administration costs for the Official Assignee under option 1.

Minimising administration costs for Inland Revenue.

44. Inland Revenue's main administration costs relate to clarifying who has the obligation to file returns of income in relation to income derived by a bankrupt during the period of bankruptcy. No material change is expected in administration costs for Inland Revenue under option 1.

Option 2 – cancel all tax losses of an insolvent individual on being released from all debt under any procedure of insolvency law

45. Under option 2, the remission income rules in the Income Tax Act would no longer apply to a person discharged from bankruptcy or who completes the "no-asset procedure" under the Insolvency Act 2006. In addition, carried-forward tax losses of a person released from all debts under any procedure of insolvency law would be cancelled. Typically, this would occur on being discharged from bankruptcy or completing the "no-asset procedure" of the Insolvency Act 2006.

46. In addition:

- The tax rules relating to disposals of tax-base property would be amended to give a tax-neutral treatment for assets vested in the Official Assignee on a person being declared bankrupt; and
- the tax rules would be clarified to ensure a bankrupt is responsible for satisfying income tax obligations relating to income derived during bankruptcy.

47. A partial release of debt may also occur under any procedure that is an alternative to bankruptcy. These procedures are intended to assist the debtor and his or her creditors by reducing debts to a level that can be managed. Existing remission rules in the Income Tax Act 2007 would continue to apply to partial remissions of debt, and carried forward tax losses may be used to offset that income. The fresh-start principle does not apply in these situations, as all debts are not fully released and the debtor is not generally required to surrender assets in exchange for that partial remission. After applying the remission income rules to partial remission of debt, any remaining balance of carried-forward tax losses remain available for carry-forward.

Maintaining the coherency of the tax system, including horizontal equity

48. Option 2 is consistent with the objective that the tax system should be neutral in relation to investment decisions. This option does not prefer any particular business structure as it results in carried-forward tax losses being cancelled irrespective of whether a sole-trader or company business structure is selected.

49. Option 2 also does not result in a preference for any particular type of business funding. It applies equally whether the business funding comes from personal savings, business debt, or debt that is not subject to the remission income rules. This is illustrated in the following example:

On discharge from bankruptcy, assume the bankrupt has a carried-forward tax loss of \$500. Under option 2, the cancellation of tax losses is neutral across all funding choices.

<i>Business funded by</i>	<i>Amount of business funding</i>	<i>Tax loss to carry- forward</i>
• <i>personal savings</i>	\$500	\$0
• <i>business debt</i>	\$500	\$0

50. Option 2 is consistent with the policy that the carry-forward of tax losses is contingent on debts that relate to deductions included in past tax losses being fully repaid and improves the coherency of the tax system.

Consistency with the objectives of insolvency law

51. Option 2 is consistent with the fresh-start principle of insolvency law. This is because the tax benefit (a tax asset) is surrendered as part of the process of being discharged from bankruptcy.

Minimising tax and compliance costs for taxpayers

52. Option 2 will result in taxpayers not needing to determine if tax losses exist on discharge from bankruptcy and this eliminates a potential wasted expense (the cost of engaging an accountant to determine if tax losses exist on discharge from bankruptcy). In addition, the taxpayer would not need to determine the tax effect of assets vesting in the Official Assignee.

Minimising administration costs for the Official Assignee

53. The Official Assignee’s administration costs would be unchanged under option 2.

Minimising administration costs for Inland Revenue.

54. Inland Revenue’s administration costs would decrease in the following areas, but due to data limitations it is not possible to determine the scale of the overall effect:

- a. the law would be clarified to ensure that the bankrupt is responsible for filing returns of income for income derived during the period of bankruptcy;
- b. it would no longer be possible for disputes to arise on whether carried forward tax losses exist on discharge from bankruptcy (although in practice this rarely occurs); and
- c. the law would be clarified to provide that:

- the rules relating to vesting of tax base property in the Official Assignee would be amended to give a tax-neutral treatment for the person declared bankrupt. This clarification is to ensure that no tax costs or benefits arise for the bankrupt as a result of being declared bankrupt. This improves consistency with the objectives of insolvency law; and
- the bankrupt is responsible for filing returns of income for income derived during the period of bankruptcy. This clarification is likely to reduce the number of contacts with bankrupts.

Option 3 – cancel tax losses partially to the extent of business debts cancelled under any procedure of insolvency law

55. Under option 3, the remission income rules in the Income Tax Act would no longer apply to a person discharged from bankruptcy or who completes the “no-asset procedure” under the Insolvency Act 2006. In addition, carried-forward tax losses of a person released from all debt under any procedure of insolvency law would be cancelled, but only to the extent the debts released are debts of the business activity. Typically, this would occur on being discharged from bankruptcy or completing the “no-asset procedure” of the Insolvency Act 2006.

56. In addition:

- the tax rules relating to vesting of tax base property in the Official Assignee would be amended to give a tax-neutral treatment for the person declared bankrupt; and
- the tax rules would be clarified to ensure that a bankrupt is responsible for satisfying income tax obligations relating to income derived during the period of bankruptcy.

57. A partial release of debt may also occur under any procedure that is an alternative to bankruptcy. These procedures are intended to assist the debtor and his or her creditors by reducing debts to a level that can be managed. Existing remission rules in the Income Tax Act 2007 would continue to apply to partial remissions of debt, and carried forward tax losses may be used to offset that income. The fresh-start principle does not apply in these situations, as all debts are not fully released and the debtor is not generally required to surrender assets in exchange for that partial remission. After applying the remission income rules to partial remission of debt, any remaining balance of carried-forward tax losses remain available for carry-forward.

Maintaining the coherency of the tax system, including horizontal equity

58. Option 3 is inconsistent with the objectives of the fresh-start principle and with the objective that the tax system should be neutral in relation to investment decisions. This inconsistency arises if carried-forward tax losses exceed business debts because that excess of the carried tax loss may continue to be carried forward after the bankrupt is released from all debts under insolvency law. Therefore, this option results in a preference for:

- the sole trader business structure over the company business structure (because not all carried-forward tax losses are cancelled for the sole trader); and
- funding for the business being from either personal savings, or from private debt. This is illustrated in the following example:

On discharge from bankruptcy, the bankrupt has a carried-forward tax loss of \$500. The effect of option 3 on carried-forward tax losses would differ as follows:

<i>Business funded by:</i>	<i>Amount of business funding</i>	<i>tax loss to carry-forward</i>
• <i>personal savings</i>	\$500	\$500
• <i>business debt</i>	\$500	\$0

59. Option 3 is inconsistent with the objectives of horizontal equity as it results in a debtor who is released from all debt continuing to be able to carry forward tax losses. That outcome is inconsistent with the coherency of the tax system.

Consistency with the objectives of insolvency law

60. Under option 3, some tax losses may continue to be carried-forward after the debtor is released from all debt. This would occur to the extent carried-forward tax losses exceed business debts cancelled on discharge from bankruptcy. In this respect, option 3 is inconsistent with the fresh-start principle of insolvency law as the benefit of carried forward tax losses (a tax asset) is still available to the discharged bankrupt.

Minimising tax and compliance costs for taxpayers

61. Option 3 will result in taxpayers being required to determine which debts cancelled on bankruptcy are business debts. The fungibility of money may make this analysis difficult to achieve or result in an incentive to treat a debt raised for personal and business purposes to be treated as being mainly on personal account. This incentive arises because the lower the level of business debt, the lower the amount of carried forward tax losses that are cancelled. This is an increase in compliance cost.

62. However, taxpayers would no longer be required to determine the tax effect of assets vesting in the Official Assignee. This is a decrease in compliance cost. Overall, it is expected that the cost of identifying the level of business debt would outweigh the cost of determining the tax effect of assets vesting in the Official Assignee. Due to data limitations, it is not possible to determine the scale of these costs.

Minimising administration costs for the Official Assignee

63. The Official Assignee's administration costs would be largely unchanged under option 3. However, as the bankrupt's business records of a business in existence prior to bankruptcy would vest in the Official Assignee, there could be some increase in compliance cost for the Official Assignee if, prior to being discharged from bankruptcy, a bankrupt seeks to determine if he or she has carried-forward tax losses.

Minimising administration costs for Inland Revenue.

64. Inland Revenue's administration costs would be likely increased under option 3. This is because the Department would need to engage with the bankrupt in determining both the level of debt that is business related and the amount, if any, of carried forward tax losses.

65. Inland Revenue's administration costs would decrease in the following areas, but due to data limitations it is not possible to determine the scale of the overall effect:

- a. the law would be clarified to ensure that the bankrupt is responsible for filing returns of income for income derived during the period of bankruptcy;
- b. it would no longer be possible for disputes to arise on whether carried forward tax losses exist on discharge from bankruptcy (although in practice this rarely occurs); and
- c. the law would be clarified to provide that:
 - the rules relating to disposals of tax base property in would be amended to give a tax-neutral treatment for the person declared bankrupt in relation to the vesting of that property in the Official Assignee. This clarification is to ensure that no tax costs or benefits arise from being declared bankrupt for consistency with the objectives of insolvency law; and
 - the bankrupt is responsible for filing returns of income for income derived during the period of bankruptcy. This clarification is likely to reduce the number of contacts with bankrupts.

Impacts of each feasible option

66. The impacts of each feasible option against the objectives of the review and the economic, fiscal, compliance and administrative impacts are summarised in Table 1: *Summary of analysis: objectives and impacts.*

Table 1 Summary of analysis: objectives and impacts

Description	Meets criteria (paragraph 30 refers)	IMPACTS					Recommendation
		Economic impact	Fiscal impact	Compliance impacts	Administration impacts	Risks	
Option 1: Status quo/	(a) and (b) are not met. (c), (d) and (e) are met.	Gives preference to sole trader business structure over company business structure. Gives preference to fund business from personal savings and debt not subject to remission income rules. Inconsistent with policy for carrying forward tax losses.	Nil	Although there is a potential for wasted expenses to arise in determining whether carried forward tax losses exist, there is no change in compliance costs as this is the effect of the status quo.	Ongoing uncertainty about application of tax law to bankrupts, including compliance obligations and the tax treatment of assets vested in the Official Assignee.	Inconsistencies between law and policy remain. Uncertainty about the application of the law to bankrupts may give rise to wasted expenses.	Does not address the problem. Not recommended.
Option 2: Cancel carried forward tax losses if all debts cancelled under insolvency law/	(a) to (e) are all met.	Has neutral effect. Consistent with policy for carrying forward tax losses.	Nil	No change in compliance costs would be expected as the outcome is largely consistent with current outcomes in practice.	A potential minor decrease in administration costs, as the value of carried forward tax losses on discharge from bankruptcy would no longer be a disputable matter.	No risks identified.	Addresses the problem. Consistent with policy objectives. Recommended method.
Option 3: Cancel carried-forward tax losses to the extent business debts cancelled under insolvency law.	(a) to (e) are not met.	Gives preference to sole trader business structure over company business structure. Gives preference to fund business from personal savings and debt not subject to remission income rules. Inconsistent with policy for carrying forward tax losses.	Nil.	A net (small) increase in compliance costs would be expected. The scale of this net increase is not able to be determined due to data limitations.	There is a risk of increased administration costs relating to determining the value of carried-forward tax losses.	Inconsistencies between law and policy remain. Risk of dispute between administrators and taxpayer on whether carried-forward tax losses exist.	Does not address the problem. Not recommended.

Economic impacts

67. Option 2 is the only option that is consistent with the policy objectives of ensuring that the tax system is neutral in relation to investment decisions. This option is also the only option that is consistent with the long-standing policy that tax losses may only be carried forward if debts relating to deductions included in past tax losses have been fully satisfied.

Fiscal impacts

68. Information provided by Inland Revenue's administration of insolvent individuals indicates that most taxpayers:

- do not have tax losses to carry-forward on discharge from bankruptcy; or
- do not have sufficient business records to determine whether carried-forward tax losses exist on discharge from bankruptcy; or
- are not willing to meet the cost of determining whether carried-forward tax losses exist on discharge from bankruptcy.

69. Consequently, option 2 is not expected to result in a fiscal impact. If option 3 were selected, there is a potential that taxpayers may seek determine that carried forward tax losses exist. Our view is that the amount of these tax losses would be immaterial.

Compliance impacts

70. There is expected to be a minor reduction in compliance impact from adopting option 2. This is because the law will be made more certain in relation to:

- the tax treatment of tax-base property vested in the Official Assignee; and
- the tax treatment of carried forward tax losses on being released from all debts under procedures of the Insolvency Act 2006.

71. However, if option 3 were adopted, compliance costs would be expected to rise, as taxpayers are required to self-assess their tax losses. In particular, a discharged bankrupt would need to have sufficient business records of the pre-bankruptcy business to establish:

- that carried forward tax losses existed on being declared bankrupt; and
- the amount of business debt that has been cancelled on discharge from bankruptcy.

Social, cultural or environmental impacts.

72. None of the options have social, cultural, or environmental impacts.

CONSULTATION

73. Policy proposals were provided in a targeted consultation letter to the Accident Compensation Corporation (ACC), Chartered Accountants: Australia and New Zealand (CAANZ), the New Zealand Law Society (NZLS), and the Official Assignee. The consultation was limited to interested parties on the basis that the proposal related to complex technical aspects of the relationship between insolvency law and taxation legislation.

The consultation letter set out policy proposals on the relationship between insolvency law and the carry forward of tax losses that arose prior to insolvency by either:

- a discharged bankrupt; or
- an insolvent individual released from the full amount of a debt under the “no-asset procedure” (an alternative to bankruptcy under the Insolvency Act 2006).

74. The policy proposals were:

- a. Whether, and to what extent, carried-forward tax losses of an insolvent person should be cancelled:
 - on discharge from bankruptcy or on completion of the no-asset procedure; and
 - to the extent partial remission of debt occurs under other alternatives to bankruptcy?
- b. Whether the differences in the income tax treatment of cancelled debts on discharge from bankruptcy result in an incentive to fund business activity in a particular way, in order to preserve carried-forward tax losses?
- c. Should timing, valuation, and deduction rules relating to disposals of assets in the Income Tax Act 2007 apply to assets vested in the Official Assignee?
- d. Should there be clarification of the income tax treatment of the bankrupt and the Official Assignee during the period of bankruptcy?

75. The consultation letter also set out an analysis of the economic impact of the status quo. That analysis indicated that under current law, the tax system was not neutral in relation to investment decisions when considering the ability to carry forward tax losses on discharge from bankruptcy.

76. The ACC submitted that it had no concerns with the policy proposals.

77. CAANZ observed that

- Some practitioners were not aware that bankrupts are technically able to carry forward tax losses that arose prior to being adjudicated bankrupt.
- In this respect, CAANZ noted that a person declared bankrupt receives a new Inland Revenue number (tax number). CAANZ acknowledged that the two tax numbers are to assist the Commissioner to distinguish between tax obligations of the bankrupt for the periods before and after bankruptcy.

78. Given that no submissions were received opposing or suggesting modifications to the policy proposals, it was concluded that the proposals to cancel all carried-forward tax losses of a person released from all debts under insolvency law should be preferred (option 2).

CONCLUSIONS AND RECOMMENDATION

79. We recommend option 2, under which:

- Carried-forward tax losses of a natural person are cancelled on discharge from bankruptcy;
- The vesting of tax base property in the Official Assignee on a person being declared bankrupt would have a tax-neutral effect for the bankrupt;
- Tax administration law would be clarified to ensure that the bankrupt is responsible for filing returns of income during his or her period of bankruptcy.

80. The proposals would be consistent with:

- the objectives of insolvency law;
- the coherency and neutrality of the tax system; and
- the long-standing policy for the carry-forward of tax losses.

IMPLEMENTATION

81. The recommended option would be included in the first available tax bill scheduled for introduction in 2016.

82. The proposal would apply to persons discharged from bankruptcy on or after the date of Royal Assent of the enabling legislation. No transitional provisions are considered necessary as the impacts would be prospective from the date the enabling legislation is first introduced into the House. When introduced into Parliament, commentary will be released explaining the amendments. Normal submission processes occur when the bill is referred to the Finance and Expenditure Committee.

83. The effect of the law would be communicated to affected taxpayers in a Technical Information Bulletin to be released shortly after the bill receives Royal assent.

84. Inland Revenue will administer the law as part of its business as usual process.

MONITORING, EVALUATION AND REVIEW

85. In general, Inland Revenue's monitoring, evaluation and review of new legislation takes place under the Generic Tax Policy Process (GTPP). The GTPP is a multi-stage tax policy process that has been used to design and implement tax policy since 1995.

86. The final stage in the GTPP contemplates the implementation and review stage, which can involve post-implementation review of the legislation and the identification of any remedial issues. Opportunities for external consultation are also built into this stage. In practice, any changes identified as necessary for the new legislation to have its intended effect would generally be added to the Tax Policy Work Programme and proposals would go through the GTPP.

87. Inland Revenue's normal assurance activity will evaluate and review that the preferred option achieves its intended policy objectives, as set out in paragraph 30 of this RIS.