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Tax Treatment of Investments in New Zealand Start-Ups

We outline below the high-level tax implications for New Zealand resident investors who invest in New Zealand start-up companies and venture capital funds. The rules are generally applicable regardless of whether the investment is made by an entity, such as a company or trust, or in an individual's personal capacity.

This advice is of a general nature and it is important to note that each investor's situation may differ depending upon their specific circumstances. We recommend that you obtain professional advice if you are uncertain about the tax treatment of your particular investment.

A person who wishes to invest in a start-up company may make their investment in one of two ways:

- directly in the start-up company, or
- via a venture capital fund that invests in start-up companies.

Investments Directly in a Start-Up Company

Where an investment is made directly in a start-up company the investor will usually receives shares in the company or a convertible note that pays interest and may be converted to shares at a later date.

Shares

To determine whether shares are held on capital account (and thus not taxable on disposal) or on revenue account (and thus taxable on disposal) consideration must be given to the investor's intention at the time of purchase.

Where an investor acquires shares in a start-up company with the intention of holding them long-term in the hope that they may at some point receive dividends it is generally accepted that the shares are held on capital account. As a result, if the shares are sold at some future point any gain on sale should not be taxable nor would any loss be deductible. In contrast, where an investor acquires shares in a start-up company with the purpose or intention of selling them the shares will be held on revenue account. Consequently, if the shares are sold any gain on sale will be taxable and any loss on sale should be deductible.

At present, most investors in start-up companies act on the assumption that they will not be subject to tax on the gains made from disposing of their shares (i.e. the shares are held on capital account). This approach has generally not been challenged by Inland Revenue.

Convertible Notes

Convertible notes are becoming a common way for investors to invest in start-up companies. The tax treatment of an investment in a convertible note depends upon the size of the investment. Smaller investors are likely to be "cash basis persons" and only need to return income on a cash receipts basis. "Cash basis persons" will be taxable on interest from a convertible note when the interest is physically paid to them. In contrast, larger investors may be taxable on an accruals basis. A reasonably complex set of calculations need to be performed in order to determine the income that arises under the accruals basis.

You may wish to seek professional advice as to whether you are required to return income on a cash basis or an accruals basis. Investors that hold a number of investments (other than shares) are more likely to be over the threshold for being a “cash basis person” and will thus be required to calculate their income on an accruals basis.

If you choose to convert the convertible note to shares in the future, there should be no additional tax to pay if the market value of the shares is higher than the amount of debt and interest provided as consideration for the conversion. If you receive no or less consideration for the convertible note that you paid for it no deduction is allowed for the loss. These principles apply regardless of whether a person returns income on a cash basis or an accrual basis.

Investments in a Venture Capital Fund

Most New Zealand venture capital funds are limited partnerships. Investors in such funds will receive limited partnership units. Limited partnerships are transparent entities which means that their income and expenditure flows through to the limited partners.

Ongoing costs incurred by a venture capital fund will generally be deductible. This expenditure then flows through to the limited partners in proportion to the amount of units they hold. The limited partners may claim the expenditure as a deduction in their own tax returns and offset the deduction against their income from other sources.

When a venture capital fund disposes of an investment in a start-up company, whether or not it is taxable will depend upon the same principles as discussed above for investments made directly in a start-up company.

Loan Interest

If an investor borrows funds to invest in a start-up company or a venture capital fund, that interest should be deductible expenditure to the investor.

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