

QUESTIONS WE'VE BEEN ASKED | PĀTAI KUA UIA MAI

Income tax – Public private partnership projects and business continuity test for losses

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QB 25/21

This question we've been asked considers whether a major change in the nature of a contractor's business activities occurs under the business continuity test for losses when a public private partnership project moves from a design and construction phase to an operating and maintenance phase.

Key provisions | Whakaratonga tāpua

Income Tax Act 2007 – s IB 3(2)(c) and IB 3(5)(d)

All legislative references are to the Income Tax Act 2007.

Background | Horopaki

Under a standard New Zealand public private partnership (PPP) project, a corporate Contractor or a corporate limited partner of a Contractor (if the Contractor is a limited partnership (LP)) may incur tax losses during the initial design and construction phase (D&C Phase). If there is a material change in the shareholding of the corporate Contractor or corporate limited partner, the relevant entity may need to rely on the business continuity test (BCT) in subpart IB to carry forward its tax losses.¹

¹ For detailed guidance on BCT refer to [IS 22/06: Loss carry-forward – continuity of business activities](#).

One requirement for applying the BCT is that no “major change” in the nature of the company’s business activities occurs during the business continuity period, unless it is a “permitted major change”.

Question | Pātai

Is there a “major change” in the nature of a PPP Contractor’s business activities when the project moves from the D&C Phase to the operation and maintenance phase (O&M Phase)? If there is a major change, is it a “permitted major change”?

Answer | Whakautu

The change from the D&C Phase to the O&M Phase could be a “major change” in the nature of the Contractor’s business activities. However, any “major change” will be a “permitted major change” because the services provided in each of the two phases are closely connected due to the economic, legal and financial dependencies of the two phases. Therefore, despite a breach in ownership continuity and the phase change, the corporate Contractor or the corporate limited partner² of an LP Contractor can carry forward its tax losses if it meets the other requirements of the BCT and the avoidance provisions in ss GB 3BA to GB 3BAC do not apply.³

Key terms | Kīanga tau tāpua

BCT means the business continuity test in subpart IB that allows a company to carry forward losses even if an ownership continuity breach has occurred.

Contractor means the special purpose vehicle (which may be a company or limited partnership) contracting with the Crown under the Project Agreement.

D&C Phase means the design and construction of the asset by the Contractor.

O&M Phase means the operation and maintenance of the asset by the Contractor.

PPP means a public private partnership involving the Crown and private sector to design, build and operate and/or maintain an asset under a Project Agreement.

² For simplicity and due to the limited scope of this question we’ve been asked, it is assumed that the corporate limited partner only undertakes activities relating to the PPP project.

³ For detailed guidance on ss GB 3BA to GB 3BAC, refer to [IS 25/14: Income tax – arrangements involving tax losses carried forward under the business continuity rules](#).

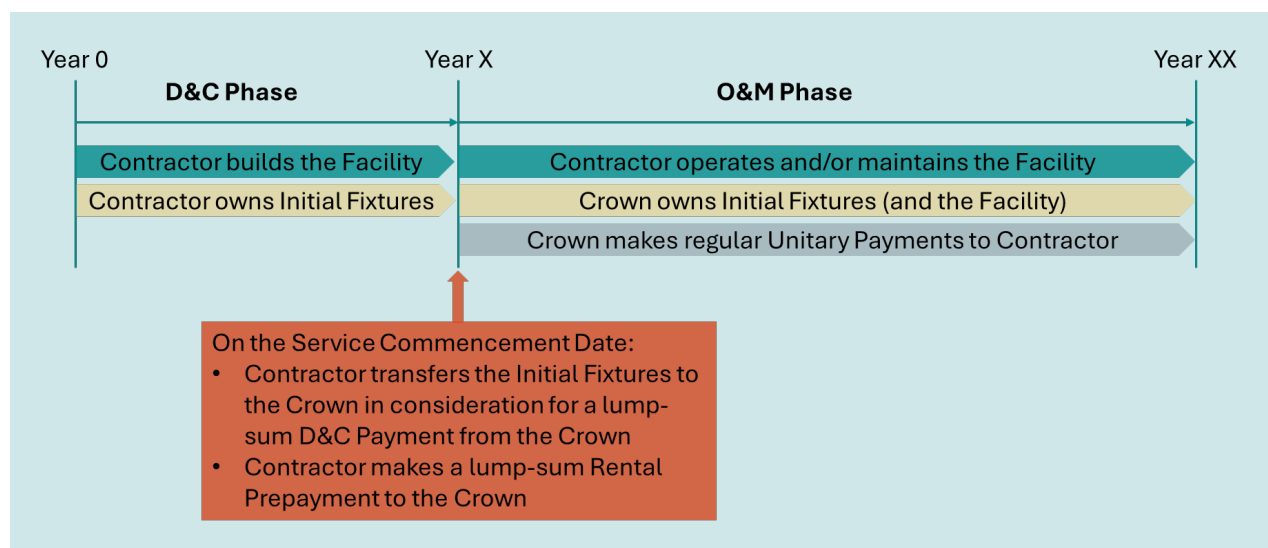
Project Agreement means the standard form Project Agreement the Crown uses for PPPs.

Explanation | Whakamāramatanga

Nature of a PPP

1. A PPP represents a long-term contract for the delivery of a service requiring the construction of a new asset or enhancement of an existing asset. Typically a PPP is financed from external sources on a non-recourse basis, and full legal ownership of the asset is retained (or returned to) the Crown.
2. PPP projects are generally governed by a standard form Project Agreement. The Project Agreement framework has three main components that are relevant to this question we've been asked:
 - the **D&C Phase** when the Contractor designs and constructs the asset (the Facility) for the Crown. Any fixtures the Contractor builds in this phase (the Initial Fixtures) are transferred to the Crown at the end of the phase in return for a lump-sum design and construction payment (D&C Payment);
 - the **Facility lease** between the Contractor and the Crown, under which the Contractor prepays an amount representing the rental the Contractor will pay to the Crown (Rental Prepayment);
 - the **O&M Phase** when the Contractor provides operational and maintenance services for the Facility over a period of approximately 25 years in return for a regular payment from the Crown (Unitary Charge). Broadly, the operational and maintenance services are those services necessary to meet asset management requirements. The services will vary depending on the type of asset being constructed.
3. Figure | Hoahoa 1 depicts the main components described above.

Figure | Hoahoa 1 – Main components of the Project Agreement framework



4. During a PPP project, the shareholding of a corporate Contractor or a corporate limited partner of a Contractor (if the Contractor is an LP)⁴ may sometimes change in the D&C Phase. If this change in shareholding breaches the 49% ownership continuity test, then the relevant corporate entity will not be able to carry forward tax losses incurred before the breach in ownership continuity unless permitted by the BCT.

Carrying forward tax losses

5. The general rule is that a company must satisfy the 49% ownership continuity test to carry forward its tax losses.
6. The BCT acts as a secondary test, permitting a company to carry a loss forward if it has a breach in ownership continuity. One of the requirements to satisfy this test is that there is **no major change** (other than a **permitted major change**) in the nature of the business activities of the company under s IB 3(2)(c).
7. If a breach occurs in the ownership continuity of a corporate Contractor or a corporate limited partner of an LP Contractor during the D&C Phase of a PPP project, to rely on the BCT to carry forward the relevant corporate entity's losses, the transition from the D&C Phase to the O&M Phase must either:
 - not be a major change in the nature of the Contractor's business activities; or
 - if it is a major change, be a permitted major change under s IB 3(5)(d).

⁴ For guidance on the attribution of partnership business activities to partners, refer to paras [54] to [58] of [IS 25/11: Income tax – Partnerships \(including limited partnerships\) – general guidance](#).

Major change

8. Section IB 3(2)(c) states:

Tax loss components for earlier income years carried forward

- (2) Despite the ownership continuity breach, a tax loss component arising in an earlier income year is carried forward to a tax year in a loss balance under section IA 3(4) (Using tax losses in tax year) if—
- ...
- (c) **no major change** in the nature of the business activities carried on by the company occurs during the business continuity period, other than 1 or more major changes that are permitted under subsection (5);
- [Emphasis added]

9. To determine whether a major change has occurred, it is necessary to examine the nature of the business activities the Contractor carries on during the D&C Phase and the O&M Phase. This examination requires considering the following factors:⁵
- the Contractor's core business processes;
 - the type of products or services produced or provided;
 - the assets factor;
 - significant suppliers or inputs;
 - scale; and
 - the main markets supplied to.
10. Table | Tūtohi 1 provides an example of how the above factors apply. It gives a high-level indicative overview of the relevant factors for a PPP project undertaken to build a highway.

⁵ Para 32 of [IS 22/06](#): Loss carry-forward – continuity of business activities (October 2022) and s IB 3(4).

Table | Tūtohi 1 – High-level overview of the relevant factors for a highway PPP project

Factor	D&C Phase	O&M Phase
Core business processes	<ul style="list-style-type: none"> Designing and constructing the highway 	<ul style="list-style-type: none"> Providing ongoing maintenance and repairs Managing road services such as toll collection and traffic monitoring
Products or services	<ul style="list-style-type: none"> The completion of the highway (including the delivery of the Initial Fixtures to the Crown) 	<ul style="list-style-type: none"> Ongoing maintenance services for the highway Traffic management and monitoring Road repair and upkeep services
Asset factor	<ul style="list-style-type: none"> Construction equipment such as bulldozers, excavators and pavers Temporary facilities for construction workers 	<ul style="list-style-type: none"> Maintenance vehicles and equipment for road repairs Traffic management systems such as cameras and sensors Tools and equipment for routine maintenance and repairs
Significant suppliers/ inputs	<ul style="list-style-type: none"> Construction materials such as asphalt, concrete, and steel Engineering and architectural services Labour for construction activities 	<ul style="list-style-type: none"> Maintenance service providers for road repairs and traffic management Suppliers of repair materials and parts Traffic monitoring and management service providers
Scale	<ul style="list-style-type: none"> Large-scale construction project involving significant resources and workforce High intensity of construction activities and coordination 	<ul style="list-style-type: none"> Routine maintenance and operations involving a smaller, more specialised workforce Lower intensity of activities focused on upkeep and operational efficiency
Main markets	<ul style="list-style-type: none"> Government 	<ul style="list-style-type: none"> Government

11. The change from the D&C Phase to the O&M Phase could be considered a “major change” under s 1B 3(2)(c) because the nature of the services the Contractor provides

during the two phases is fundamentally different (as in Table | Tūtohi 1). The D&C Phase involves significantly more complexity, cost and resources to construct the asset compared with the operation and maintenance of the asset during the O&M Phase.

12. However, even if a change is considered to be major under s IB 3(2)(c), a company continues to meet the requirement under that section if the change is a “permitted major change” under s IB 3(5)(d).

Permitted major change

13. Section IB 3(5)(d) states:

Permitted major changes

- (5) A major change in the nature of the business activities carried on by the company during the business continuity period does not breach the requirement set out in subsection (2)(c) if the major change is –

...

- (d) caused by a change in the type of products or services the company produces or provides that involves the company starting to produce or provide a product or service using the same, or mainly the same, assets as, or that is otherwise **closely connected with**, a product or service that the company produced or provided immediately before the beginning of the business continuity period.

[Emphasis added]

14. Accordingly, to satisfy s IB 3(5)(d), services provided during the O&M Phase must be “closely connected” with services provided during the D&C Phase.
15. The term “closely connected” is not defined in the Act. “Close” in the *Concise Oxford English Dictionary* (12th ed, New York, Oxford University Press) in the context of a connection means strong. One meaning for “connected” as defined in the *Concise Oxford English Dictionary* is joined or linked together. Therefore, the connection between the new product or service and existing products or services needs to be strong. Some examples, as noted in IS 22/06, could include products or services:
- based on the same underlying technology;
 - that significantly enhance the utility or enjoyment of existing products or services; or
 - that are commonly sold together with existing products or services in order to enhance the sales of those products or services.

16. The services provided during the O&M Phase are “closely connected” with the services provided during the D&C Phase for the following reasons:
- The Project Agreement incorporates both the D&C Phase and O&M Phase. The Facility constructed during the D&C Phase, including the Initial Fixtures transferred to the Crown, creates the physical infrastructure on which the O&M services are performed. Therefore, the O&M services are inherently linked to services undertaken in the D&C Phase because they are carried out on the very infrastructure that is designed and built during the D&C Phase.
 - Under the Project Agreement, the Contractor must ensure the Facility achieves operational completion by no later than the planned Service Commencement Date. This requirement directly ties the services provided during the D&C Phase to the readiness of the Facility for operational services, highlighting the inherent connection between these phases.
 - The base case financial model integrates the financial planning for both the D&C Phase and the O&M Phase. It includes assumptions and projections that cover the entire lifecycle of the project, ensuring that the financial viability of the operational services is directly linked to the successful completion of the design and construction phases.
 - The Unitary Charge, which is the fee payable by the Crown during the O&M Phase, is calculated from the base case. This charge reflects the financial requirements of both the D&C and O&M Phases, and is expected to recover all of the Contractor’s costs in relation to the project and provide its profit margin for the whole project.
17. Therefore, any major change from the D&C Phase to the O&M Phase under the Project Agreement will be a permitted major change under s IB 3(5)(d). The relevant corporate entity can rely on the BCT to carry forward its tax losses if it meets the other requirements of s IB 3 and if the avoidance provisions in ss GB 3BA to GB 3BAC do not apply.
18. The Commissioner considers the above outcome (that the BCT allows the relevant corporate entity to carry forward its tax losses) applies even if the relevant corporate entity subcontracts the physical work to another party.

References | Tohutoro

Legislative references | Tohutoro whakatureture

Income Tax Act 2007, ss IB 3, GB 3BA – GB 3BAC

Other references | Tohutoro anō

Concise Oxford English Dictionary (12th ed, New York, Oxford University Press)

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About this document | Mō tēnei tuhinga

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