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WEEKLY COMMENT: WEDNESDAY 18 JULY 2012

1. Earlier this year Inland Revenue released a draft Questions We've Been Asked on *Income Tax – Whether residual land is part of an undertaking or scheme of development or division of land*, on which comments closed on 11 May. This week I discuss:
   - The question and answer in the draft QWBA;
   - The issues that arise in connection with identifying the residual land (not considered in any detail in the draft QWBA); and
   - The GST implications, which need to be carefully thought through (also not considered in the draft QWBA).

The draft QWBA

2. The question addressed is:

   "A block of land is purchased and subdivided. All but one of the newly formed lots are sold and the remaining lot is kept for the owner's purposes. Will the amount derived on the eventual sale of that retained lot be income (under section CB 12 or CB 13)?"

3. Sections CB 12 and CB 13 bring to tax income from disposing of land, where an undertaking or scheme, *not necessarily in the nature of a business*, involving the development of the land or the division of the land into lots, was commenced within 10 years of acquisition by or on behalf of the taxpayer, and:
   - The development or division work is not minor (section CB 12): or
   - The development or division work involves significant expenditure on channeling, contouring, drainage, earthworks, kerbing, leveling, roading, or any other amenity, services, or work customarily undertaken in major commercial or residential land development projects (section CB 13).

4. What constitutes work of a minor nature is covered in a previously issued Interpretation Guideline IG00010 *Work of a Minor Nature* subsequently published in *Tax Information Bulletin*: Vol 17, No.1 (February 2005).

5. The answer given is:

   The amount derived on the eventual sale of the retained lot will not be income under sections CB 12 or 13 *if it can be established that the retained land was always intended to be kept for the taxpayer's own purposes* and not disposed of as part of the undertaking or scheme of division of the original block into lots. (emphasis added)

6. It is stated that this will be a question of fact and will require consideration of all of the circumstances, including, for example:

   (a) The subdivision plans;

   (b) Any contracts or agreements entered into;

   (c) Evidence as to the intended use of the retained land;

   (d) What ultimately happened to the retained land; and

   (e) The reasons for the ultimate sale of the land that was retained.

7. If the retained lot is part of a subsequent undertaking or scheme falling within sections CB 12 or 13, the amount derived on disposal would be income.

8. It is stated that the *Work of a Minor Nature* IG should not be relied on to the extent that it suggests that the amount derived from the retained lot will be taxable.

What land?

9. The initial issue is what land the undertaking or scheme must have been carried out on:

   - The particular part or lot that is disposed of; or
   - A larger block of land of which the land disposed of formed only a part.

10. The answer given in the draft QWBA is that the particular land or lot disposed of need not have been itself developed or subdivided.

11. This answer relies on the existence of section CB 23B (which brings to tax an amount derived upon the sale of part of the land to which the a taxing section, including sections CB 12 and 13, applies) and on the decision in *Lowe v CIR* (1981) 5 NZTC 61,006 (CA) where the reference to "the land" was held to be reference to any part of the land on which an undertaking or scheme was carried out.

Residual land

12. The key issue in the draft QWBA is: what is "residual land", and there are two aspects here:

   - Whether it can it be part of the undertaking or scheme, or must be separate; and
   - If it is part of an undertaking or scheme, how the residual land is to be identified.

The residual land can be part of the undertaking or scheme

13. It is stated in the draft QWBA that:

   "The Commissioner considers that it can be inferred from a number of cases (eg *Cross v CIR* (1987) 9 NZTC 6,101 (CA) and *Church v CIR* (1992) 14 NZTC 9,196 (HC)) that an undertaking or scheme of division of land into lots can be confined to that part of the larger parcel that was intended to be sol off as part of the scheme."

14. Reference is made to the following subdivision, where an original entire parcel of land is subdivided. Lots "B" to "I" were intended to be sold off. If it can be established that Lot "A" was never intended to be part of the scheme of development, it will be "residual land" and any amount derived on a subsequent sale of Lot "A" will not be taxable under sections CB 12 or CB 13.

A			
B	**C**	**D**	**E**
F	**G**	**H**	**I**

15. (Note: the proceeds from the sale of Lot "A" may be taxable under some other provision in the rules that tax gains from the sale of land, and that will have to be separately considered.)

16. In *Church* three subdivision plans lodged over some years were not taken together and regarded as part of a scheme of subdivision of the whole block. While it could be argued that a wider scheme of subdivision must have existed at the outset, the Court held that the scope of the undertaking or scheme only extended to that portion of the original block that is intended to be sold off as part of the undertaking or scheme.

17. In *Cross* the Court of Appeal rejected the taxpayers' submission that there were three separate undertakings. However, it is noted in the draft QWBA that it may be inferred that the scope of the undertaking or scheme extends only to that portion of the original block that is intended to be sold off as part of the undertaking or scheme.

Boundary adjustments

18. The question of what happens when a boundary is adjusted so that one of two adjoining lots can be sold is also addressed in the draft QWBA.

19. The conclusion is that, unless the boundary adjustment was effected in order to sell both lots, only the amount derived from the lot to be sold will be within the ambit of sections CB 12 or 13. The remaining lot will be "residual land" and a subsequent sale will not be tainted by the boundary adjustment.

20. This conclusion differs from the one in *the Work of a Minor Nature* IG.

Identifying the residual land

21. It is stated in the draft QWBA that an amount derived upon the sale of residual land will not be taxable under sections CB 12 or 13 *if it can be established that the retained land was always intended to be kept for the taxpayer's own purposes*. The type of supporting evidence referred to has been listed in paragraph 6 above. No further details are provided regarding how the separation of the residual land is to be established.

22. The Law Society has made a submission on this point: that the taxpayer may have no fixed preference at the time of acquisition as to which lot might be retained. The Law Society notes that:

    "Comments in the draft response could be read as suggesting that the taxpayer's intention to retain must be able to be demonstrated in respect of a specific part of the relevant land at the time it is acquired or committed to development….

    … (The Law Society) sees no reason in law or policy why the retained land need be specifically identifiable at the time of acquisition or at the commencement of a scheme if an intention to retain <u>some part of the land</u> can be demonstrated at the relevant time."

23. In *Morrow v CIR* (1989) 11 NZTC 6,053, Doogue J had a great deal of difficulty identifying the separate intention. That case concerned whether property had been acquired for the purpose of sale. A key aspect was the sketch plan, which in the Judge's view:

    "… clearly negated any thought of the rear portion of the land being retained by the then owner as no legal access is shown in respect of it."

24. However, there was another major difficulty – that the area which might have been treated as "residual land" was not defined:

    "… it is quite impossible for me to see into his (the Objector's) head to ascertain what that area of land might have been or would have been if he held such an intention at the time of acquisition. The Objector defined the area in relation to the seven acre block but that seven acre block was entirely a creature of the the ultimate line of the motorway which was not known to the Objector at the time of acquisition.

    … The area that he intended to keep has never been clearly defined other than by reference to the position of the stable on the aerial map….

    Whilst both counsel work upon the premise, from the decided cases, that it was possible to have a separate intention in respect of separate parts of the land, I do find it difficult to apply that proposition to a situation such as the present when there has been no definition of any description other than an after the event description by virtue of an accidental act, namely the motorway line, of the areas that the Objector intended to retain….

    In saying this I do not wish to be critical of the Objector. It seems to me to be very clearly understandable what has occurred in this case, namely that the Objector has purchased the whole of the 15 acre block with the intention of subdividing and selling as much of the block as was immediately capable of being subdivided and sold, with the position of *the area of land at the extreme north being slightly uncertain at that time*.

    I am also satisfied that the Objector had the intention to live on the land whilst this process was occurring but *it does not follow that he had entirely clear separate intentions* in respect of separate parts of the land…" (emphasis added)

25. Whatever the case, it seems clear based on *Morrow* (and to some extent on *Church* and *Cross*) that it would be definitely more advisable to clearly identify the residual land at the outset, or as close to the outset as possible, and to document that fact with supporting evidence.

GST Implications

26. The GST implications are not covered in the draft QWBA. *Case N59* (1991) 13 NZTC 3,457 concerned the GST on the sale of a home unit that was held to be part of an undertaking or scheme involving development or division of land into lots and was not work of a minor nature.

27. The facts in brief were that a husband and wife acquired a section of land and erected two home units. One of the units was to be sold to the wife's mother at cost, and the other was to be retained as a long-term investment. Soon after the project commenced the wife's mother decided not to buy the unit, which was put up for sale and sold on 11 September 1986. Due to financial difficulties the second unit was also put up for sale, and sold on 19 June 1987.

28. The second sale followed the introduction of GST, and the Commissioner assessed GST on the second sale. The Objectors submitted that they were not in the business of dealing in property, had no record, history or pattern of trading in property and that the sale of the units was not part of their taxable activity.

29. The Commissioner relied on section 67(4)(e) of the Income Tax Act 1976, which is the predecessor to section CB 12. Counsel for the Commissioner referred to *Aubrey v C of IR* as authority that the preparation and obtaining of the District Land Registrar's approval of a scheme plan of subdivision and the lodging of the plan in the Land Transfer Office constitutes "division work".

30. Barber DJ noted that *Dobson v C of IR* (1987) 9 NZTC 6,025 suggests that the preparation of flats plans may be regarded as work of a minor nature and that the bisection of a lot is, of itself, work of a minor nature. However, he found that the division work in this case:

    "… cannot normally be regarded as work of a minor nature. The minimum division work involved surveying, preparation of the flat plans, lodging and depositing the same at a Land Transfer Office, drafting and execution of cross-leases, and obtaining of separate composite titles. I do not think that a conveyancing solicitor would regard such work as of a minor nature in relation to these two sale transactions even though it may be routine."

31. In any case, it is accepted law that not much needs to be done in order for there to be an undertaking or scheme that is not minor, and is therefore within the ambit of section CB 12. In *Lowe* Richardson J discussed the concept of work of a minor nature:

    "Whether the work is of a minor nature must, it seems, depend on an overall assessment of such matters as the time, effort and expense involved, measured in both absolute terms and relative to the nature of the value of the land on which the work is done. More importantly for present purposes, division as an alternative to development and the limitation of the exception to work of a minor nature suggest *that not a great deal is required by way of activity to constitute a plan or programme of action an undertaking or scheme under the paragraph*." (emphasis added)

32. In terms of the GST question of whether there was a taxable activity, the judge accepted the submissions of Counsel for the Commissioner:

    "… that a long-term "one-off" transaction may satisfy the requirements of the statutory definition of a "taxable activity" and that the continuous background to this transaction is sufficient to make the supply a "taxable activity" in view of the deeming provision of section 6(2) (which includes commencement and termination matters in the taxable activity). … the "taxable activity" was not merely the sale of the second unit, but included all the preparatory work necessary to get the development under way e.g. the clearing of land, surveying, engineering work, depositing of plan, the cross-leasing and erection and eventual sale of the units."

33. There is a definite risk that a sale following an undertaking or scheme as contemplated in sections CB 12 or 13 could constitute a taxable activity. The issue is whether the subsequent sale of the retained or residual land is part of the same taxable activity.

34. The answer will turn on the particular facts. Where the undertaking or scheme is not carried out as part of any broader taxable activity by a registered person, there should be a basis for deregistration prior to any subsequent sale. In the case of a sale by a registered person in the course of a taxable activity, the sale may or may not have to be zero-rated

depending on whether it is a sale to a registered person who meets the requirement for zero-rating or not.

35. There could also be input tax implications upon acquisition, in relation to any residual land that is to be retained. Under the compulsory zero-rating rules, there may be output tax payable by a purchaser who is a registered person.

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