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WEEKLY COMMENT: FRIDAY 15 MAY 2015

1. This week I look at QB 15/04 *Income tax – Whether it is possible that the disposal of land that is part of an undertaking or scheme involving the development or division will not give rise to income, even if no exclusion applies* released on 13 April 2015 and published in *Tax Information Bulletin* Vol. 27 No. 4, May 2015, pp. 37-51.

2. An earlier draft of this QWBA was consulted on in 2012. I discussed the earlier draft in *Weekly Comment* 18 July 2012. The main differences between the approach taken in the previous draft of the item and QB 15/04 are:

   (a) The previous draft QWBA considered the scope of the undertaking or scheme to be confined to the land the taxpayer intended to sell as part of the undertaking or scheme. The approach in QB 15/04 is that **all** of the land in the relevant block (or blocks) is involved in the undertaking or scheme, but that the amount derived on the disposal of land that is involved in the undertaking or scheme will not be income under s. CB 12 or s. CB 13 if it can be satisfactorily established that the undertaking or scheme was not carried on with a view to disposal of **that land**.

   (b) The previous draft QWBA referred to the provisions not applying to land that the taxpayer **intended** to retain. In QB 15/04 the Commissioner considers that it is more accurate to say that the provisions will not apply if the taxpayer can show that the undertaking or scheme was not carried on **with a view to the disposal of the land in question**.

Sections CB 12 and CB 13

3. Sections CB 12 and CB 13 bring to tax as income of a person, amounts 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 carried on by or on behalf of the person on or relating to the land, and:

   (a) The development or division work is not minor and the undertaking or scheme was begun within 10 years of the date on which the person acquired the land (section CB 12): or

   (b) 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 or provided in major projects involving the development of land for commercial, industrial, or residential purposes (section CB 13).

4. Section CB 13 was covered in last week's *Weekly Comment*. What constitutes work of a minor nature is covered in Interpretation Guideline IG00010 *Work of a Minor Nature* published in *Tax Information Bulletin* Vol. 17, No.1, February 2005.

5. Sections CB 12 and CB 13 are overridden by the exclusions for residential land in s. CB 17, for business premises in s. CB 20, for farm land in s. CB 21, and for investment land in s. CB 23. The discussion in QB 15/04 concerns circumstances where none of these exclusions apply.

QB 15/04

6. QB 15/04 concerns the situation where land has been divided and/or developed and some of it sold, while some of it is retained by the owner. The question concerns whether, if none of the exclusions in paragraph 5 above apply:

   (a) It is possible for the retained land to not be "tainted" by the division work, so that the amount derived on the eventual disposal of that land will not be income; or

   (b) If land has been developed but not divided, it is possible that the amount derived upon the ultimate sale of the retained land is not income.

7. The Commissioner's position is that if an undertaking or scheme involving development or division has been carried on (and meets the other criteria in s. CB 12 or s. CB 13) the proceeds on disposal of all of the land will be taxable under the relevant provision unless one of the exclusions in paragraph 5 above applies. However, the Commissioner will accept that s. CB 12 or s. CB 13 does not apply to the disposal of any given part of the land if the taxpayer can provide satisfactory evidence that the undertaking or scheme was not carried on with a view to the disposal of **that land**. The Commissioner would expect to see evidence that there had been some other demonstrable plan in relation to the land in question.

Distinction between land disposed of and land that is part of an undertaking or scheme

8. As in the 2012 draft, the Commissioner distinguishes between:

   (a) The "land", in the opening words of s. CB 12 and s. CB 13, from which income may be derived upon disposal – which must logically be the land actually disposed of; and

   (b) The "land" subsequently referred to in paragraphs (b), (c) and (e) of s. CB 12 and paragraph (b) of s. CB 13, which should be read as referring to the land involved in the undertaking or scheme.

9. This distinction is supported by the existence of s. CB 23B (which recognises that the land disposed of in any given year may be only part of the land involved in the undertaking or scheme) and *Lowe v CIR* (1981) 5 NZTC 61,006 (CA).

10. However, the notable difference from the 2012 draft is that Commissioner no longer considers that the undertaking or scheme is confined to the part of the larger parcel that was intended to be sold off as part of the scheme. In the 2012 draft the Commissioner interpreted the decision in *Church v CIR* (1992) 14 NZTC 9,196 (HC) as supporting the view that the scope of an undertaking or scheme only extends to that portion of the original block that is intended to be sold off as part of the undertaking or scheme. In contrast, the Commissioner's current views in QB 15/04 may be summarised as follows:

    (a) The Commissioner considers that the "land" referred to in paragraphs (b), (c) and (e) of s. CB 12 is the physical land within the title (or titles) that are involved in the undertaking or scheme. If any of the land comprised in a particular title is developed, there has been development of "the land" involved in the undertaking or scheme.

    (b) An undertaking or scheme of development or division may involve land in more than one block (or certificate of title).

(c) If an undertaking or scheme involving development work on a block was carried on, all of the land is involved in the undertaking or scheme. Even if only part of the block of land is developed, the Commissioner does not consider it correct to regard only the part that was physically developed as being involved in the undertaking or scheme of development.

(d) In the case of an undertaking or scheme of division of land into lots, the undertaking or scheme necessarily involves the whole original block.

What is an undertaking or scheme and when it commences

11. QB 15/04 contains a brief discussion about what constitutes an undertaking or scheme and when it would be regarded as having commenced.

12. In *Lowe*, Richardson J noted there is an element of vagueness and elasticity inherent in both the words "undertaking" and "scheme", and in the composite expression, but considered that "scheme" connotes a plan or purpose which is coherent, and has some unity of conception, and similarly an undertaking is a project or enterprise organised and directed to an end result. Not a great deal is necessarily required for there to be an undertaking or scheme involving development or division.

13. In *Smith v CIR* (1987) 9 NZTC 6,045 (HC) it was held there could be an undertaking or scheme despite the fact no physical work had taken place and no contractual commitment had been entered into within the ten-year period.

14. The details do not have to be settled for there to be an undertaking or scheme capable of being carried out. Some details may be later modified without making the original scheme a new scheme altogether, as in *Cross v CIR* (1987) 9 NZTC 6,101 (CA).

15. The date of commencement is when the first step in carrying out the scheme takes place; when there is some act done that sets it in train, as in *Cross*. It is a question of fact in any given case as to whether the undertaking or scheme has moved beyond conception to having been put into operation. There must be some overt act done for the purpose of implementing the undertaking or scheme. However, it does not need to be immediately commenced.

16. Importantly, it is noted in QB 15/04 that the fact that an undertaking or scheme may have to be modified or abandoned does not mean that it was not commenced. Neither s. CB 12 nor s. CB 13 require that the undertaking or scheme is carried out (i.e. completed), just that it is carried on. The wording of the predecessor provision to s. CB 12 and s. CB 13 was "carried on or carried out" which made this clearer.

17. There could be a variety of things that indicate that an undertaking or scheme has been commenced, for example:

(a) Applying for local authority consent, assent or direction to proceed being given to persons engaged to carry the work out in whole or in part;

(b) Some physical activity on the land;

(c) Entering into a contract or arrangement by which the undertaking or scheme is put into operation, as in *Cross*;

(d) The hearing of an application for planning approval by way of specified departure, which preceded any contract-letting or other steps, marked the commencement of the undertaking or scheme in *Smith v CIR* (No 2) (1989) 11 NZTC 6,018 (CA);

(e) It was noted in *Smith (No 2)* that it was possible that the making or notifying of a planning application could itself potentially be enough.

When an amount derived on disposal is not income

18. The Commissioner considers the better view is that s. CB 12 and s. CB 13 were not intended to operate to the extent that an undertaking or scheme involving development or division was not carried on with a view to disposal.

19. The October 1967 recommendation of the Taxation Review Committee (the Ross Committee) was that the legislation ought to catch undertakings or schemes aimed at making a profit but entered into or devised after the purchase of the land.

20. The Commissioner considers that overall the case law supports the view that s. CB 12 and s. CB 13 only give rise to income if an undertaking or scheme was carried on with a view to disposal of the land in question:

(a) In *Church*, there were a number of subdivisions of the land over the years, some within the 10-year period after the taxpayer acquired the land, but the High Court found that the subsequent sales were not part of a continuing scheme that commenced within the 10-year period, indicating, in the Commissioner's view, that the fact that land was involved in an undertaking or scheme does not necessarily mean the amounts derived on the sale of the land will be income.

(b) In *Cross* the taxpayer argued for a later (and consequently, higher) commencement value by contending that there were three successive schemes, and the court implicitly accepted the possibility of there being three separate schemes, although it rejected the taxpayer's contention in that case, suggesting, in the Commissioner's view, that a scheme meeting the criteria in s. CB 12 and CB 13 will not necessarily give rise to a tax liability for all of the land when it is eventually sold.

(c) In *O'Toole v CIR* (1985) 7 NZTC 5,045 (HC), the taxpayers subdivided a whole farm with a view to selling off some of the blocks, and the use by the judge of the words "the scheme existed in the plan or purpose to sell off the lots not reserved by the objectors for their own use in order to realise the maximum available profit" has been interpreted by the Commissioner as implying that although the judge considered that though all of the land was involved in the scheme of division, the provision was not concerned with that part of the land that the taxpayers retained for their own purposes, but rather just with the land that the taxpayers had a view to disposing of.

(d) In *Paul Stephens Construction Limited v CIR* (1990) 12 NZTC 7,192 (HC), where two adjacent sections were subdivided within 10 years of acquiring one of the sections but not the other, the profit from the sale of the lots from the section acquired earlier was not taxable, which indicates, in the Commissioner's view, that the s. CB 12 or s. CB 13 criteria must be considered in relation to each piece of land sold, as not all of the land will necessarily meet the criteria.

(e) Three cases would appear to support the opposite view, that it is irrelevant whether the undertaking or scheme was carried on with a view to retaining rather than disposing of some of the land: *Anzamco Ltd (in liq) v CIR* (1983) 6 NZTC 61,522 (HC), where, the Commissioner suggests, the law was not interpreted as intended and exclusions were subsequently legislated, *Case J37* (1987) 9 NZTC 1,219, which the Commissioner apparently does not place any reliance on, and *Wellington v CIR* (1981) 5 NZTC 61,101

(HC), in which there was an exclusion available to the taxpayers and the judge decided the exclusion was the only way the land sales would not be taxable.

(f) The judge's comments in *Lowe* should not, in the Commissioner's view, be read as suggesting that all of the land is necessarily "tainted" by the undertaking or scheme, and the ultimate sales will therefore all be subject to tax, because the judge's comments related specifically to the taxpayer's argument in that case and should not be taken more broadly.

Evidence to establish that there was no view to dispose of the land

21. The types of things that may be relevant in establishing that an undertaking or scheme was not carried on with a view to the disposal of the land in question include:

(a) The details of the development or subdivision plans, resource consent applications etc.;

(b) Any contracts or agreements entered into;

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

(d) Whether the taxpayer apportioned costs relating to the development or division work between land they had a view to disposal of and land they are claiming they did not;

(e) What ultimately happened in respect of the land in question; and

(f) The reason(s) for the ultimate disposal of the land in question.

22. If an undertaking or scheme meeting the criteria in s. CB 12 or s. CB 13 is carried on, it does not matter when the disposal of land occurs. The mere passage of time will not, without other supporting evidence, necessarily be sufficient to show that the undertaking or scheme was not carried on with a view to the disposal of the land in question.

23. It is only necessary that an undertaking or scheme meeting the relevant criteria has been carried on, it does not need to have been carried out (i.e. brought to fruition). If an undertaking or scheme meeting the relevant criteria was carried on but was subsequently abandoned, the ultimate disposal of the land will still be caught by the relevant provision unless an exclusion applies or the taxpayer can establish that the undertaking or scheme was not carried on with a view to disposal of the land in question.

Boundary adjustments

24. The Commissioner has retracted the view in IG0010 *Work of a minor nature* published in *Tax Information Bulletin* Vol. 17, No. 1, February 2005, that all sales following a boundary adjustment of adjoining lots owned by the same person will result in taxable income.

25. The Commissioner's current view, in QB 15/04, is that whether amounts derived on the disposal of any of the resulting lots following a boundary adjustment will be income under s. CB 12 depends on whether the undertaking or scheme involving the boundary adjustment was carried on with a view to the disposal of the land in question.

Examples

26. QB 15/04 contains 2 examples:

(a) **Example 1** concerns a situation where the taxpayers buy a block of land to build their home on and decide that the block is too big, so they subdivide the block into 4 lots, sell 3 and retain one on which their house is built. The example is intended to demonstrate that

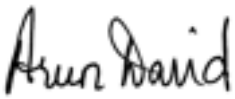
the subsequent sale of the lot on which their house was built will not be taxable in the same way as the 3 other lots, although all 4 lots were part of the undertaking or scheme.

(b) **Example 2** concerns a more complicated scenario, and is essentially a combination of the facts in *Paul Stephens Construction* and *O'Toole*, where two adjacent sections are subdivided within 10 years of acquiring one of the sections but not the other, with some of the land earmarked for retention and use by the taxpayer. The conclusions are that:

(i) The sale of the lots that relate to the section acquired earlier do not result in taxable income because the undertaking or scheme was not commenced within 10 years;

(ii) The subsequent sale of part of the land earmarked originally earmarked for retention and use by the taxpayer did not result in taxable income because the undertaking or scheme was not commenced with a view to disposing of that land; and

(iii) The eventual sale of land originally earmarked for sale and within the section where work was commenced within 10 years resulted in taxable despite a decision part way through the process not to proceed with the sale of that land.



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