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WEEKLY COMMENT: FRIDAY 10 JULY 2015

1. Budget 2015 contained a number of so-called “property compliance proposals”. Last week I looked at the measures to improve information gathering and promote enforcement of offshore persons’ tax obligations contained in the *Taxation (Land Information and Offshore Persons Information) Bill* (“the Tax Information Bill”). This week I will review the proposals relating to the bright-line test contained in *Bright-line test for sales of residential property – An officials’ issues paper* (“the Bright-line Test Issues Paper”), released on 29 June 2015.
2. The bright-line test will apply to residential properties for which an agreement to purchase was entered into on or after 1 October 2015, and will require income tax to be paid on any gains from the sale of residential property that is bought and sold within two years. There are to be very limited exceptions, for the main family home, and in certain circumstances when the seller did not intend to acquire the property (inheritances and relationship property, with rollover relief applying to the latter).

Application date of the bright-line test

3. The bright-line test would apply to residential properties for which an agreement for sale and purchase is entered into from 1 October 2015, and which are subsequently disposed of.
4. For properties acquired other than by way of sale, the bright-line test would apply to properties for which registration of title occurs after 1 October 2015.

Date of acquisition and disposal

5. In order to determine whether a property is acquired and disposed of within two years, it will be necessary to determine the acquisition and the disposal date.
6. The following are the proposals for the acquisition date:
 - (a) In general, the date of acquisition should be the date that title is registered for the purchase, which provides a definite date recorded on Landonline that can easily be used by sellers and Inland Revenue to know when the bright-line period starts;
 - (b) In the case of a sale of subdivided land, the general rule would apply and the date of acquisition of the subdivided land by an owner would be the original date of acquisition of the undivided land – i.e. the date the title was registered for the purchase of the undivided land;
 - (c) An exception would apply in the case of a sale of a right to buy property (i.e. when a person sells their interest in property before the date of registration), and the acquisition date

would be when a person entered into a sale and purchase agreement to acquire the property.

7. The following are the proposals for the disposal date:
 - (a) In general, the date of disposal should be date on which a person enters into a contract to sell the property;
 - (b) In the case where a disposal does not involve a contract to sell (for example a gift), the date of disposal will be determined according to ordinary rules;
 - (c) In cases where disposals occur as a result of individual or corporate insolvency, officials have invited submissions on how the bright-line test should apply.
8. The reasons advanced for using the date of registration of title in general for the acquisition date, and the date of entering into a sale and purchase agreement for sales of the right to buy property, are as follows:
 - (a) Using the current land sales rule under which the acquisition date is the date a person enters into a sale and purchase agreement is problematic because a seller may not have access to the original sale and purchase agreement, which would make it difficult to verify the date;
 - (b) With a definite date such as the registration date it will be easier to implement a withholding tax, because it will be easier for purchasers to know whether they need to withhold because the sale is subject to the bright-line;
 - (c) When a sale of the right to buy property occurs within two years of acquiring that right, the bright-line test should apply if a person disposes of residential property before taking legal ownership and the disposal was within two years of the seller entering into a sale and purchase agreement.
9. The date a person enters a contract to sell is proposed for the date of disposal in order to counter potential avoidance measures, such as deferring the date of registration of the sale to a date that is more than 2 years after the acquisition registration date, even though a contract to sell may have been entered into within the bright-line 2-year time period.

Definition of “residential land”

10. The bright-line test would apply only to residential land. The proposed definition of “residential land” has apparently been drafted so as to appropriately define the boundary between residential property and property developments (including mixed-use land and bare land) and commercial, industrial or agricultural property, which will not be affected. The definition proposed is the same as the one in proposed s. 156A(1) of the *Land Transfer Act 1952* (“LTA 1952”) discussed last week.
11. As discussed last week, the definition includes “land that has a dwelling on it” and “land for which there is an arrangement to build a dwelling on it”. The second criterion is apparently intended to capture sales where the land is bare or currently being used for commercial or other purposes but is proposed to be developed into residential properties.
12. The proposed definition of “dwelling” is also the same as the one in proposed s. 156A(1) of the LTA 1952 discussed last week. It will essentially be the same as the current definition in the *Income Tax Act 2007* (“ITA 2007”), with the inclusion of services apartments. Apparently to ensure that investors in services apartments are subject to the bright-line test.

13. However, a person who owns and operates services apartments as a business will not be subject to the bright-line test because there will be a business premises exception. Consistent with the definition of residential land proposed in s. 156A(1) of the LTA 1952 discussed last week, “residential land” will not include land used predominantly as business premises or as farmland.
14. The suggested definition of “business premises” is land that is the premises of a business. The definition of “farmland” will be the same as the one proposed in s. 156A(1) of the LTA 1952 – i.e. land that, because of its area and nature, is capable of being worked as an economic unit as a farming or agricultural business.
15. The current definition of “land” in s. YA 1 of the ITA 2007 includes any estate or interest in land, and includes an option to acquire land or an estate or interest in land. Mortgages are not included. It is noted that this means “land” for the purposes of applying the bright-line test will include freehold and leasehold estates in land. Apparently the definition of “land” is to be clarified so that there is no doubt that it includes an interest in land.

Main home exception

16. The bright-line test will not apply to the disposal of the main home of the vendor. The proposal is that the main home exception, which will be determined based on actual rather than intended use of a property, will apply when:
 - (a) The land has a dwelling on it (the main home exception cannot be used for land that does not have a dwelling on it, such as a subdivided part of a larger property with a main home where there is no dwelling on the subdivided portion);
 - (b) The dwelling is occupied mainly as the residence by the owner (which is the test for the residential exclusion in the current taxation of land sales rules, and will ensure properties used for investment or other purposes are not covered); and
 - (c) The dwelling is the main home of the owner.
17. There is a proposed definition of “main home” in s. 156A(1) of the LTA 1952 discussed last week, which is the home used mainly as the person’s residence and with which the person has the greatest connection. The proposal is to flesh out the “greatest connection” requirement for the purposes of the bright-line test by reference to factors used to determine a person’s permanent place of abode in the tax residence rules, including:
 - (a) The time the person occupies in the dwelling;
 - (b) Where their immediate family (if any) live;
 - (c) Where their social ties are strongest;
 - (d) The person’s use of the dwelling;
 - (e) The person’s employment, business interests and economic ties to the area where the dwelling is located; and
 - (f) Whether the person’s personal property is in the dwelling.
18. If the property is owned by a trust, the proposal is that the main home exception would apply if the dwelling is occupied mainly as a residence by a beneficiary of the trust, and is the main home of the beneficiary of the trust.

19. However, the main home exception will not apply to any property owned by a trust if the settlor of the trust has a main home that is not owned by the trust, or the settlor is a beneficiary of another trust that owns the main home for the settlor. This is apparently to prevent trust ownership being used to claim the main home exception for more than one residence if a person's family members live in different dwellings.
20. There is no proposal to limit the number of main homes that could be bought and sold within two years. It is noted that the "habitual renovator" would be captured by the intention test in the current taxation of land sales rules. However, as discussed last week, tax information must be provided if a transferor has relied on the main home exemption at least twice within the 2 years immediately preceding the date of the transfer – i.e. the sale of the third main home within a 2-year period will not be an exempt transfer for the purposes of the information gathering rules.

Exception for inherited property

21. The proposal is that there will be no tax liability for the executor or administrator or the beneficiary under a will arising through the application of the bright-line test to any inherited property. The bright-line test would apply in the usual way to any person who subsequently acquires the property from the beneficiary.
22. The Bright-line Test Issues Paper contains quite a useful summary of the current tax rules surrounding the death of a taxpayer. In essence, there are two transfers – one from the deceased to the executor or administrator, and the other from the administrator to the beneficiary. Both transfers can have tax consequences, but not if the beneficiary is a surviving spouse, close relative or a charity. In the latter case, "rollover relief" applies and for this purpose the beneficiary inherits the tax characteristics of the deceased.
23. There are two potential disposals that the bright-line test could apply to: the disposal by the deceased to the beneficiary and the subsequent disposal by the beneficiary. If the bright-line test is applied based on the current rules, the consequences could be as follows:
- (a) If the property passes to a beneficiary with no rollover relief:
 - (i) A disposal upon the death of a taxpayer could trigger the bright-line test if it occurs within 2 years of when the deceased acquired the property; and
 - (ii) A subsequent disposal by the beneficiary would trigger the bright-line test if it occurs within 2 years of when the beneficiary inherited the property.
 - (b) If the property passes to a beneficiary with rollover relief, a subsequent disposal by the beneficiary would trigger the bright-line test if it occurs within 2 years of when the deceased acquired the property.
24. Neither of these outcomes are seen as appropriate, given that the beneficiary did not intend to acquire the property. Therefore, the proposal is that, for the purposes of the bright-line test only, the disposal from the deceased to the beneficiary and any subsequent disposal by the beneficiary are both ignored. The current taxation of land sales rules would continue to apply as at present.

Exception for relationship property

25. The proposal is that the current rollover relief for property transferred under a relationship property agreement would apply for the purposes of the bright-line test. The bright-line test

would apply to any subsequent disposal by the transferee under a relationship property agreement – i.e. if the transferee disposes of the property within 2 years of the transferor's registration date of the property, the proceeds would be taxable.

26. The rationale for following a different approach from when property is inherited is that the transferee could reasonably be regarded as having the same intention as the transferor when the property was jointly acquired, and there is an opportunity to negotiate the property that a transferee receives under a relationship property agreement.

Deduction of expenditure on property taxable under the bright-line test

27. The proposal is that taxpayers liable for tax under the bright-line test will be able to deduct expenditure according to the ordinary rules. In particular:

(a) The cost of the property can be deducted at the time of sale, including:

- (i) The amount paid to acquire the property; and
- (ii) Expenditure related to the acquisition (such as costs of lawyers, valuers, surveyors and real estate agents: and
- (iii) The cost of capital improvements to the property after acquisition, such as renovations; and
- (iv) The incidental costs of disposing of the property.

(b) Holding costs, such as interest, insurance, rates and repairs and maintenance expenses, can be deducted under the current rules:

- (i) Holding costs can be deducted to the extent they have a nexus with income and are not private in nature;
- (ii) When a property is rented out there is likely to be a nexus between holding costs and rental income;
- (iii) Holding costs relating to a bach purchased for private use and sold within 2 years would not be deductible – i.e. holding costs that are currently not deductible will not become deductible because of the bright-line test.

Proposed treatment of tax losses upon disposal of a property within 2 years

28. The current taxation of land sales rules allow unrestricted deduction of losses incurred. However, officials are concerned that importing this unrestricted allowance into the tax rules relating to the bright-line test would create an incentive for taxpayers with unrealised losses to accelerate sales to get within the 2-year period, whereas taxpayers with unrealised gains would defer sales to be beyond the 2-year period.

29. Officials have suggested ring-fencing losses claimable due to the bright-line test, so they are only able to be offset against taxable gains on other land sales. The ring-fencing would apply only to losses that arose solely due to the application of the bright-line test, and not to losses arising under any of the other taxation of land sales rules.

30. A further restriction is proposed in relation to properties transferred to associated persons. Officials are concerned at the possibility that the loss on a property that has declined in value could be realised by transferring the property to an associated person. They have proposed that a person should not be able to recognise a loss under the bright-line test arising from a transfer of property to an associated person.

Sale of shares in a land-rich company or transfer through a land-rich trust

31. Officials are concerned that the bright-line test could be avoided through holding property in companies or trusts and selling the shares in the company or changing the terms of the trust so that the beneficial ownership of the trust assets is transferred.
32. Officials favour a specific anti-avoidance rule that applies for the purposes of the bright-line test only, but have left open the possibility of more general rules that could apply to the taxation of land sales rules generally.
33. In the case of a land-rich company, officials have proposed that there would be a deemed disposal of property held by the company if there is a disposal of shares with the purpose or effect of defeating the intent and application of the bright-line test. The tax liability would be with the selling shareholder.
34. In the case of trusts, an anti-avoidance rule is suggested (similar in operation to s. YC 9(2) which states when the single notional person rule would not apply to trustees for the purpose of determining shareholding continuity) that would deem a disposal of property held by a trust to have occurred if any of the following is done with the purpose or effect of defeating the intent and application of the bright-line test:
 - (a) A change in the trustees of the trust;
 - (b) A change in the beneficiaries of the trust;
 - (c) A change in the identity of any person who is able to appoint the trustee or the beneficiaries of a trust;
 - (d) A change in the ownership of a corporate trustee.
35. The tax liability would be either with the trustee as trustee income, or it could be with the beneficiary, as beneficiary income.



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