

## WEEKLY COMMENT: FRIDAY 3 JUNE 2022

1. The *Taxation (Annual Rates for 2021–22, GST, and Remedial Matters) Act 2022* (“the March 2022 Tax Act”), which received the Royal assent on 30 March 2022, contains the new rules relating to interest deductibility for residential properties and the corresponding changes to the bright-line test. Inland Revenue issued *Special Report on Public Act 2022 No 10* (“the March 2022 SR”) on 31 March 2022 on interest limitation and additional bright-line test rules.
2. This week and for the next two weeks, I review the additional bright-line test rules. This week I look at the new bright-line test rules, the bright-line acquisition dates, and the implications for co-ownership of property. Next week I will look at the rollover trust rules and week-after-next I will look at the main home exclusion rules.

### **Application of the new bright-line test rules vs the “old” bright-line test rules**

3. Section CB 6A has been repealed and replaced with effect from 27 March 2021. Section 48(2) of the March 2022 Tax Act provides that the new s CB 6A:
  - (a) Applies to a person’s disposal of residential land, if the person acquires an estate or interest in the land on or after 27 March 2021;
  - (b) Does not apply if the person makes an offer for the acquisition of the land, on or before 23 March 2021, that is irrevocable before 27 March 2021 and the person acquires an estate or interest in the land on or after 27 March 2021 as a result of that offer;
  - (c) Does not apply to:
    - (i) A person’s disposal of a freehold estate in residential land that the person acquired as the owner of a leasehold estate with a perpetual right of renewal, if the person was granted the leasehold estate before 27 March 2021;
    - (ii) A person’s disposal of an estate or interest in residential land that the person acquired as the result of the completion of a land development or subdivision, if before 27 March 2021 the person entered into the agreement under which they acquired the estate or interest upon the completion of the land development or subdivision.
4. The “old” bright-line test rules in s CZ 39 apply to properties acquired before 27 March 2021 (and on or after 29 March 2018). The test for these properties remains a 5-year test and the “old” main home exclusion rules in s CZ 40 apply to these properties. These 5-year test rules are essentially the same as the rules originally enacted with a 2-year test, except

for the increase to 5 years. Refer to *Weekly Comment* 26 February 2016 for a discussion of these “old” rules.

5. For properties acquired before 29 March 2018 and on or after 1 October 2015, the original bright-line test was a 2-year test, as mentioned above, meaning that the bright-line test rules will not apply to the disposal of such properties. The bright-line test rules do not apply at all to properties acquired before 1 October 2015.

### **The new bright-line test rules**

6. Section CB 6A(2) provides that a person has income from disposing of residential land that is, as defined in s CB 6A(1):
  - (a) 10-year test land: which means residential land to the extent to which, using a land area test, it is not new build land, and the land’s bright-line disposal date is within 10 years of the earliest of any of the applicable bright-line acquisition dates in s CB 6A(3) to (7C);
  - (b) 5-year test land: which means residential land to the extent to which, using a land area test, it is new build land, and:
    - (i) The person acquires it no later than 12 months after the land becomes new build land; and
    - (ii) The land’s bright-line disposal date is within 5 years of the earliest of any of the applicable bright-line acquisition dates in s CB 6A(3) to (7C); and
    - (iii) At the time of its disposal or at the time the instrument to transfer the land to another person is registered as described in s CB 6A(3)(a), it meets the requirements of paragraph (a), (b), (d), (e), or (f) of the definition of new build land or would have met 1 of those requirements but for the destruction of the relevant place by natural disaster or fire.
7. “New build land” is defined in s DH 5(7) and the definition is set out in full in paragraphs 4 – 9 of *Weekly Comment* 13 May 2022. In broad terms:
  - (a) The land must have a self-contained residence for which a code compliance certificate (“CCC”) was issued on or after 27 March 2020, in which case, “new build land” includes the residence itself, land used by the residents, and related shared areas;
  - (b) Other land for which a CCC has been issued on or after 27 March 2020, being:
    - (i) Land for which there is an agreement to add a residence;
    - (ii) Hotels or motels converted into residences; and
    - (iii) Residences for which earthquake strengthening or weather-proofing remediation work has been undertaken.
8. Note the following in respect of “5-year test land”:
  - (a) The 5-year test commences on the bright-line acquisition date for the land – see paragraph 11 below – regardless of when a new build is added – the bright-line acquisition date is not re-set when a new build is added;

- (b) For the 5-year test to apply, there must be a residence on the land when sold – land which is new build land under paragraph (c) of the definition, being land to which a residence is expected to be added, will not qualify as 5-year test land if a residence has not been added and a CCC issued before it is sold – such land will be subject to the 10-year test if sold between 5 and 10 years after acquisition;
  - (c) Land continues to be 5-year test land, under the third limb, if, at the time of disposal, there would have been a new build except that it was destroyed by a natural disaster or fire;
  - (d) The 12-month test applies to the first and subsequent purchasers, as long as the person acquires it no later than 12 months after it becomes new build land;
  - (e) If land that was previously new build land is acquired after 12 months, the addition of a new residence to the land will result in new build land relating to the new residence only;
  - (f) The use of the words “to the extent that” and the reference to a “land area test” mean that:
    - (i) The portion of the land with the relevant new build on it is subject to the 5-year new build bright-line test, including the land immediately beneath the new build, outdoor areas exclusive to the new build, and a reasonable proportion of shared areas;
    - (ii) The remaining portion of the land is subject to the 10-year bright-line test;
    - (iii) The “land area test” means that apportionment must be based on the square meterage of the land attributable to the relevant new build and the remaining portion of the land - a valuation-based apportionment method may not be used;
    - (iv) The relevant “new build” proportion would be the area covered by the new residence, exclusive related land area, and portion of shared area (such as, for example, 50% of a common driveway), as a proportion of the total land area being disposed of.
9. Section CB 6A(2B) provides that the bright-line test rules in s CB 6A do not apply to amounts derived, by an executor or administrator of a deceased estate, or a beneficiary of a deceased estate, from disposing of residential land.

### **Bright-line acquisition dates**

10. The applicable bright-line acquisition dates are given by s CB 6A(3) to (7C). Sections CB 6A(7), (7B) and (7C) concern land transferred for certain family trusts, Maori authorities and land included in settlement of claim under the treaty of Waitangi and are dealt with in next week’s *Weekly Comment* as part of Maori rollover trusts.
11. The bright-line acquisition dates under s CB 6A(3) to (6) are as follows:
- (a) Section CB 6A(3) sets the general bright-line acquisition date as:
    - (i) The date on which the instrument to transfer the land to the person was registered under the land Transfer Act 2017, or an equivalent foreign law in the case of foreign land; or

- (ii) The latest date on which the person acquires the estate or interest in the land, if an instrument to transfer the land to the person is not registered before the bright-line disposal date;
- (b) Section CB 6A(4) and (4A) apply to subdivisions and provide that for residential land that results from subdividing previous undivided land, the bright-line acquisition date is:
- (i) The date on which the instrument to transfer the undivided land to the person was registered under the Land Transfer Act 2017, or an equivalent foreign law in the case of foreign land; or
  - (ii) For transfers reflecting changes of trustees of the same trust, the earliest date on which the undivided land was registered to a trustee of the trust; or
  - (iii) The latest date on which the person acquires the estate or interest in the undivided land, if an instrument to transfer the land to the person is not registered before the bright-line date;
- (c) Section CB 6A(5) applies to leases with a perpetual right of renewal, in which case, the bright-line acquisition date is the date the leasehold estate was granted;
- (d) Section CB 6A(5B) and (5C) concern changes from a joint tenancy to a tenancy in common and vice versa:
- (i) Where a joint tenancy with equal joint owners is converted to a tenancy in common with the same equal joint owners, the bright-line acquisition date is the date on which the joint tenancy was acquired; and
  - (ii) Where a tenancy in common with equal joint owners is converted to a joint tenancy with the same equal joint owners, the bright-line acquisition date is the date on which the tenancy in common was acquired;
- (e) Section CB 6A(5D) concerns distinguishing pre-existing land in cases where land sold is part of pre-existing land or land acquired is merged with pre-existing land, in which case, the instrument of transfer is treated as not being for the pre-existing land;
- (f) Section CB 6A(6) provides that for land acquired upon the completion of a land development or subdivision, the bright-line acquisition date is the date on which the agreement to acquire the land was entered into.

### **Changing the form of co-ownership**

12. New s CB 6A(5B) and (5C) clarify that, to the extent to which the economic ownership of the land has not changed, the bright-line clock is not reset when a transfer instrument is registered to effect a change in the form of co-ownership of land.
13. Section CB 6A(5B) applies when a joint tenancy is converted to a tenancy in common. The section provides that, to the extent to which residential land is held as a tenant in common in a share equal to all the other joint owners and to the extent that it was previously held under a joint tenancy with each of the same joint owners holding equal nominal shares, the bright-line acquisition date is the date the joint tenancy was acquired.

14. Section CB 6A(5C) applies in the reverse situation when a tenancy in common is converted to a joint tenancy. It provides that, to the extent to which residential land is held under a joint tenancy with each of the joint owners holding equal nominal shares and to the extent that it was previously held under a tenancy in common with all the same joint owners holding equal shares, the bright-line acquisition date is the date the tenancy in common in equal shares was acquired.

### **Changes in co-ownership proportions**

15. New s CB 6A(5D) clarifies that the bright-line clock is reset only for the newly acquired share when there is a change in ownership proportions. The section applies when a transfer of residential land that is co-owned by two or more persons results in a change in co-ownership proportions (but not necessarily in the form of co-ownership), or when ownership of residential land changes from sole ownership to a form of co-ownership, or vice versa. It provides that the instrument of transfer is treated as not being for land that is:

- (a) Transferred by a person and, immediately before the transfer, the land was part of other land (referred to as “pre-existing land”) that a person owned; or
- (b) Transferred to a person and, after the transfer, the land merges with other land that the person owns (also referred to as “pre-existing land”).

16. Sections CB 6A(5B) and (5C), which apply when the form of co-ownership changes from joint tenants to tenants in common and vice versa, still apply in the situation when there is a change in co-ownership proportions that occurs simultaneously with the change in the form of co-ownership. This means that the bright-line clock is reset only to the extent to which there is a change in co-ownership proportions – the same result as in the case where only the co-ownership proportions change and not the form of co-ownership.

17. Inland Revenue notes that this changes the position suggested in the recently published (September 2021) draft interpretation statement Income tax – application of the land sale rules to changes in co-ownership, subdivisions, and changes of trustees – that the bright-line clock for the portion of land *not* disposed of was reset on each disposal of a part share, in addition to the portion that was disposed of. That position, as stated in the draft interpretation statement, is now wrong.



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