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WEEKLY COMMENT: FRIDAY 19 FEBRUARY 2016

1. This week and in the next two weeks I look at the amendments in the *Taxation (Bright-line Test for Residential Land) Act 2015* (“the Bright-line Test Act”). A “bright-line test is a term used in law for a clearly defined rule or standard, using objective factors, which is designed to produce predictable and consistent results. This week I look at:
 - (a) The application date;
 - (b) Existing land tax rules take precedence;
 - (c) Bright-line test applies even for land disposed of together with other land;
 - (d) Basic rule: bright-line test for residential land disposed of within 2 years;
 - (e) Residential land;
 - (f) Properties outside New Zealand;
 - (g) Bright-line date;
 - (h) Date of acquisition;
 - (i) Deed of nomination;
2. Next week I will look at the rules for subdivisions, leases with a perpetual right of renewal, and contingent interests, the main home exclusion, deductions and ring-fencing of losses. Week-after-next I will finish off by looking at rollover relief, how the rules apply to transfers between associated persons, anti-avoidance rules and the new filing exemption for non-active trusts.

Application date

3. Under s. 4(2) of the Bright-line Test Act, the bright-line test rules in s. CB 6A of the *Income Tax Act 2007* apply to a person’s disposal of “residential land” (see paragraph 13 onwards below) if the date that the person first acquires an estate or interest in the residential land is on or after 1 October 2015. It is stated in *Tax Information Bulletin* Vol. 28 No. 1 February 2016 (“the TIB Item”) that the date a person acquires their “first interest” is the same date as when they acquire land for the purposes of s. CB 15B. As a result, guidance on section CB 15B can be used to assist in determining when a person’s “first interest” in land was acquired.
4. When there is a standard acquisition of land, under s. CB 15B the date the person first acquires an estate, interest or option that is land is the date that begins a period in which the person has an estate or interest in, or an option to acquire, the land, alone or jointly or in common with another person – i.e. essentially when the person enters into an agreement to purchase the land. Therefore, the bright-line test rules will apply to residential land where the

agreement to acquire the land (or shares in a flat- or office-owning company) is entered into on or after 1 October 2015.

5. Officials stated in the *Officials' Report to the Finance and Expenditure Committee on Submissions on the Taxation (Bright-line Test for Residential Land) Bill* ("the Officials' Report") that when land is acquired other than by sale, generally, the first estate or interest the person acquires will be acquired on the date of registration of title for the land. As a result, in most cases where land is acquired other than by sale, the bright-line will apply if registration of title is on or after 1 October 2015 (and it meets the other requirements of the bright-line test).
6. However, when land is acquired before registration of title, or without there being registration of title, the application date for the bright-line test will be the date they acquire that first interest in the land and not the date of registration of title.
7. The s. YA 1 definition of "estate" for land (meaning an estate in land, and including a right, through a trustee or otherwise, to possession, receipt of rent or profits and proceeds from disposal) has been broadened so as to:
 - (a) Apply not only to "estate in relation to land" but also to "interest in relation to land" "estate or interest in land", "interest in land" and similar terms; and
 - (b) Specify that the right to possession of the land, directly or through a trustee or otherwise, includes a licence to occupy as defined in s. 121A of the *Land Transfer Act 1952* ("the LTA") – i.e. a right to occupy a flat or office as a shareholder in a flat- or office-owning company.

Existing land tax rules take precedence

8. Under s. CB 6A(6) the bright-line test rules apply to a disposal of land only if none of ss. CB 6 to CB 12 apply – i.e. only if the proceeds from the disposal of the land are not taxed under these sections.
9. However, the bright-line test rules take precedence over ss. CB 13 and CB 14. Sections CB 13 (where the proceeds relate to an undertaking or scheme of developing the land or dividing the land into lots involving significant expenditure) and CB 14 (where the land is sold within 10 years and the gain arose due to changes in laws or regulations affecting the land) both only apply if the other land tax rules in sections CB 6 to CB 12 do not apply. Sections CB 13 and CB 14 will now only apply if the bright-line test rules in s. CB 6A also do not apply to the land being disposed of (ss. 5 and 6 of the Bright-line Test Act).

Bright-line test applies even if land is disposed of together with other land

10. Under an amendment to s. CB 23B, the bright-line test rules in s. CB 6A will apply to an amount from the disposal of land regardless of whether:
 - (a) The land is part of the land to which s. CB 6A applies; or
 - (b) The land is the whole of the land to which s. CB 6A applies; or
 - (c) The land is disposed of together with other land.

Basic rule: bright-line test for residential land disposed of within 2 years

11. Under the basic rule, the start date of the bright-line period is the date the transfer of land is registered to the person under the LTA and the end date (referred to as the "bright-line date") is the date a person enters into an agreement to dispose of the land.

12. Specifically, the basic rule, under s. CB 6A(1), is that an amount a person derives from the disposal of “residential land” is income of the person:
- (a) If the “bright-line date” for the residential land is within 2 years of:
 - (i) The registration date of the instrument to transfer the land to the person under either the LTA or equivalent foreign laws if the land is outside New Zealand; or
 - (ii) The “date of acquisition” of the land if the instrument to transfer the land to the person is not registered on or before the bright-line date; and
 - (b) The “main home exclusion” in s. CB 16A does not apply (which will be discussed next week); and
 - (c) The person is not an executor or administrator or a beneficiary disposing of residential land that was transferred to them on the death of a person (the disposal of such residential land is exempt from the bright-line test rules, as will be discussed week-after-next).

Residential land

13. The rule applies only to disposals of “residential land”. Officials stated in the Officials’ Report that the “residential exclusion” in s. CB 16 is not limited to 1 property and was not suitable for bright-line purposes because:
- (a) A person could use the residential exclusion in s. CB 16 for both their main home and their bach or holiday house; and
 - (b) A person could use trusts to obtain the residential exclusion a multitude of times for properties that the person does not live in.
14. Consequently, there is a new definition of “residential land” for the purposes of the bright-line test in s. YA 1 meaning:
- (a) Land that has a “dwelling” (defined in s. YA 1 when the changes to the tax depreciation rules eliminated depreciation on buildings) on it:
 - (i) “Dwelling” in s. YA 1 means “any place used predominantly as a place of residence or abode, including any appurtenances belonging to or enjoyed with the place”;
 - (ii) “Dwelling in s. YA 1 excludes *in whole or part* hospitals, hotels and motels and hostels and boarding houses, convalescent homes and nursing homes or hospices (note the amendment to insert the words *in whole or part* means that the existence of a hotel or motel in part of a building will not exclude the whole building from being a dwelling);
 - (iii) Specifically for the purposes of the bright-line test only, “dwelling” includes serviced apartments and excludes rest homes or retirement villages in whole or in part;
 - (b) Land for which the owner has an arrangement that relates to erecting a dwelling (as explained in the TIB Item, this criterion would apply when the owner of a commercial office has an arrangement to convert it into dwellings;
 - (c) Bare land that may be used for erecting a dwelling under rules in the relevant operative district plan.
15. Despite the above, the following types of land are not “residential land”:
- (a) Land used predominantly as business premises;
 - (b) Land used as farmland, which is defined in s. YA 1 as meaning:

- (i) Land that is being worked in the farming or agricultural business of the land's owner;
or
 - (ii) Land that, because of its area and nature, is capable of being worked as a farming or agricultural business.
16. Officials consider that "business premises" in the context of the bright-line would include land, buildings, appurtenances, and parts of lands or buildings for use in the carrying on of a business. In the TIB Item it is stated that "business premises" has its ordinary meaning as within the rest of the *Income Tax Act 2007*, which will generally require there to be a building on the land and this building to be occupied by a person in the course of running their business.
17. Officials do not consider further detail in defining a business premises is necessary or desirable given that it is meant to be applied in a wide range of circumstances and is intended to have its ordinary meaning. Officials also do not consider that the ordinary meaning of "business premises" would include land that is occupied by a third party for residential purposes. Where property is occupied partly for residential purposes and partly for business premises (for example, serviced apartments) it will be a boundary situation that would need to be determined on the facts and circumstances of the specific case. The following examples are provided in the TIB Item:
- (a) A bed and breakfast where meals are provided to the residents and the rooms are serviced and cleaned every day would be regarded as predominantly used as business premises;
 - (b) A factory which also has workers quarters that employees use as residences would be regarded as predominantly used as business premises;
 - (c) A purchaser of an empty factory who plans to develop it into an apartment building will not be regarded as using the land predominantly as business premises.
18. It is stated in the TIB Item that determining whether there is a farming or agricultural business on the land requires looking at the same factors that determine whether there is a business under general tax law – i.e. looking at the nature of the activities carried on and the intention of the taxpayer in undertaking these activities.
19. The Finance and Expenditure Committee stated that the definition of "farmland" should make it clear that the exemption from the bright-line rules is intended to apply to land used for a farming or agricultural business, but not to a lifestyle block or hobby farm. However, the Committee also stated that "a small parcel of land would be exempt if it were used in combination with other land for a farming business" Officials stated in the Officials' Report that this would cover circumstances where an individual plot was too small to be farmed on its own but is farmed in combination with adjoining land owned by someone else.
20. It is noted in the TIB Item that even if there is no farming business being run on the land, it can still be considered farmland if the land is capable of being worked as a farming or agricultural business. Determining whether land is capable of being worked requires looking at the capability of the land at the time of the disposal. Land that requires significant investment or modification to be used as a farming business would therefore not qualify. The following examples are provided in the TIB Item:
- (a) A lifestyle block with a house and a small area of farmland on which a small number of sheep are kept on the land to keep the grass down is not farmland because it is not being

worked as a farming business nor is it capable of being worked as a farming business – it is a hobby farm;

- (b) A 50 hectare plot of land covered in gorse is not farmland as it is not capable of being used for farming purposes;
- (c) A 5 hectare plot of land suitable for use as a rose farm is farmland, as it is currently capable of being used for farming purposes.

21. Officials have confirmed that business premises and farmland exclusion requires the land be used predominantly as business premises or farmland, but not necessarily by the transferor.

Properties outside New Zealand

22. Officials stated in the Officials' Report that the bright-line test should apply to properties outside New Zealand when they fall within the bright-line period. Hence the reference to the registration of foreign land transfers in the basic rule in paragraph 12(a)(i) above. The normal foreign tax credit rules would apply to land subject to the bright-line test. However, under s. BD 1(4), the bright-line test will not apply to overseas land sold by a non-resident.

Bright-line date

23. Officials stated in the Officials' Report that income taxable under the bright-line rule is intended to be recognised in the year it is derived under general principles rather than solely by the "date of disposal". Therefore, they recommended introducing the concept of the "bright-line date" to determine if the bright-line rule would apply (as opposed to "date of disposal").

24. "Bright-line date", under s. CB 6A(7), is essentially the date of disposal of residential land determined as the earliest of the following dates:

- (a) The date that the person enters into an agreement for the disposal;
- (b) The date on which the person makes a gift of the residential land;
- (c) The date on which the person's residential land is compulsorily acquired by the Crown or a local or public authority;
- (d) The date the land is disposed of by a mortgagee, if the land is mortgaged and the mortgagee defaulted on repayments; or
- (e) If none of the above apply, the date on which the "estate or interest in land" (refer to **paragraph 7** above) is disposed of.

25. It is stated in the TIB Item that:

- (a) For gifts, the end date for the bright-line period will be the date when the donor has done everything necessary to be done in order to transfer the property and render the settlement binding, which for a gift of a registrable interest in land, will mean the end date for the bright-line period is the date the interest is registered, and as gifts of land are treated as if they are transferred at market value under ss. FC 1(1) and FC 2, any gain over the cost will be taxable under s. CB 6A.
- (b) When the land is compulsorily acquired by the Crown, the proposed end date of the bright-line period is the date that the land is compulsorily acquired, which will generally be 14 days after the proclamation taking the land is published in the *Gazette*.

- (c) When land is disposed of by a mortgagee exercising their right to dispose of the property, the end date for the bright-line period is the date when the land is disposed of by the mortgagee.
 - (d) If there is another type of disposal of land, the date of disposal is the date that the land is disposed of according to ordinary rules.
26. Officials have stated in the Officials' Report that in their view the expiry of a lease is not a disposal of the lease. Hence the bright-line test will not apply upon the expiry of a lease.

Date of acquisition

27. "Date of acquisition" is defined in s. CB 6A(7) as meaning "the latest date on which the person acquires the estate or interest in the residential land." Note that the ordinary rule on when land is acquired in s. CB 15B ("the date that begins a period in which the person has an estate or interest in, or an option to acquire, the land, alone or jointly or in common with another person – i.e. essentially when the person enters into an agreement to purchase the land) is "switched off", under s. 7 of the Bright-line Test Act, for disposals of residential land if the date the person first acquires an estate or interest in the residential land is on or after 1 October 2015.
28. However, Officials have stated in the Officials' Report that:
- (a) The "latest date" requirement is necessary to address situations where there may be several stages involved in acquiring the same interest or where an interest is converted into an estate;
 - (b) The date is the latest date on which the particular estate or interest being disposed of was acquired.
29. It is stated in the TIB Item that for a sale of a contract to buy land, the "latest date" will be the date that a person enters into a contract to purchase the property. This means that for a sale of a contract to buy, the bright-line period runs from the date that a person enters into a contract to purchase the land to the date that a person enters into a contract to sell the land.

Deed of nomination

30. Officials made the following comments in the Officials' Report regarding the circumstances where the purchaser of a property nominates another third-party person to be the purchaser under a Deed of Nomination:
- (a) A third party nomination is the same as the sale of a right to buy land: a purchaser of land acquires an interest in the land by entering into a contract to purchase the land (they acquire a right to buy the land), and if they enter a Deed of Nomination, they are transferring this interest (the right to buy the land) to another party;
 - (b) The start date of the bright-line for this person is the date the person entered into the contract to purchase the land, because the latest date they acquired the interest is the date they entered into the contract to purchase;
 - (c) The end date of the bright-line would be the date they entered into a deed of nomination, because the "date of disposal" is the date that the person entered into an agreement for the disposal, being the Deed of Nomination, which is an agreement for the disposal of the land;

- (d) There is no rollover relief for transfers of property to associated persons, therefore, the start date for associated-party nominations would be the same as for third-party nominations.
31. The TIB Item clarifies that in circumstances where the nominee subsequently sells the land, there are 2 acquisitions and disposals:
- (a) The first acquisition and disposal is by the nominator and begins when the contract to purchase the land is entered into and ends on the date of the deed of nomination; and
 - (b) The second acquisition and disposal is by the nominee and begins on the date the registered title is transferred to the nominee and ends on the date the nominee enters into an agreement to sell the land.



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