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AUSTRALIA + NEW ZEALAND

WEEKLY COMMENT: FRIDAY 26 FEBRUARY 2016

1. This week I continue looking at the amendments in the *Taxation (Bright-line Test for Residential Land) Act 2015* ("the Bright-line Test Act"). This week I look at:

   (a) The bright-line test for subdivisions;

   (b) The bright-line test for leases with a perpetual right of renewal;

   (c) The bright-line test for contingent interests;

   (d) The main home exclusion;

   (e) Deductions;

   (f) Ring-fenced allocations of deductions for disposals of residential land within 2 years; and

   (g) No group loss offset for losses under the bright-line rule.

2. Next week I will finish off by looking at the rules for rollover relief, application to associated persons, anti-avoidance rules and the new filing exemption for non-active trusts.

Bright-line test for subdivisions

3. The start date of the bright-line period for subdivided land is earlier than the start date under the standard rules – it is the date the owner originally acquired the undivided land.

4. Specifically, the rule for subdivisions, under s. CB 6A(2) of the *Income Tax Act 2007*, is that an amount a person derives from disposing of "residential land" (as discussed last week from paragraph 13 onwards) that results from the person subdividing other ("undivided") land is income of the person:

   (a) If the "bright-line date" (as discussed last week from paragraph 23 onwards) for the residential land is within 2 years of:

      (i) The registration date of the instrument to transfer the undivided land to the person under either the *Land Transfer Act 1952* ("the LTA") or equivalent foreign laws if the land is outside New Zealand; or

      (ii) The "date of acquisition" (as discussed last week from paragraph 27 onwards) of the undivided land if the instrument to transfer the undivided land to the person is not registered on or before the bright-line date and

   (b) 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 next week).

5. Note that the undivided land need not be "residential land". 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 the use of the term "land" as opposed to "residential land" makes it clear that the wider definition of "land" applies.

Bright-line test for leases with a perpetual right of renewal

6. When a person has a lease with a perpetual right of renewal which they then convert into freehold land, the start date for the bright-line period is the date the person is granted the lease. This is consistent with other tax provisions that treat a lease with a perpetual right of renewal similar to freehold estates.

7. Specifically, where a person converts a leasehold estate with a perpetual right of renewal into a freehold estate in land, and subsequently disposes of the freehold estate, the amount the person derives from disposing of the freehold estate, under s. CB 6A(3), is income if the "bright-line date" (as discussed last week from paragraph 23 onwards) for the freehold estate is within 2 years of the grant of the leasehold estate. In other words, the person is treated as if the person held the freehold estate for the whole period that they had the leasehold estate. Officials considered that leases with a perpetual right of renewal are very similar to freehold title and should be treated similarly.

8. Note that the reference to "land" is being replaced with "residential land", in an amendment proposed in clause 37(1) of the *Taxation (Residential Land Withholding Tax, GST on Online Services, and Student Loans) Bill* ("the RLWT Bill"), to clarify that this rule is confined to "residential land" (as discussed last week from paragraph 13 onwards).

9. *Tax Information Bulletin* Vol. 28 No. 1 February 2016 ("the TIB Item") clarifies the fact that this rule does not apply to ordinary leases where the lessee subsequently acquires the land. In such cases, the start date for the bright-line test will be the date of registration of the title for the purchase under the standard rule.

Bright-line test for contingent interests

10. A sale "off the plan" for the bright-line test is where a person enters into a contract to acquire a parcel of land that is being developed or subdivided. At the time the person enters into the contract, the title for the land they are agreeing to purchase does not yet exist (as the land needs to be subdivided or developed before separate title can be issued). The person is agreeing to acquire registered title in the land once a separate title exists.

11. Officials stated in the Officials' Report that in circumstances where a person has a sale "off the plan" which they later obtained registered title to, the person would be able to start the 2-year period at the date they entered into a contract to purchase the property.

12. Specifically, an amount a person derives from disposing of a freehold estate in land acquired upon completion of a land development or subdivision, is income if the "bright-line date" (as discussed last week from paragraph 23 onwards) is within 2 years of the person acquiring an interest, in relation to the land, that is contingent upon the completion of the development or subdivision.

13. Again, the reference to "land" is being replaced with "residential land", in an amendment proposed in clause 37(2) of the RLWT Bill, to clarify that this rule is confined to "residential land" (as discussed last week from paragraph 13 onwards).

Main home exclusion

14. Under s. CB 16A, the rules for taxing property subject to the bright-line tests in s. CB 6A do not apply to the disposal of a "main home" (as discussed in **paragraph 15** below):

    (a) For a person disposing of their own residential land, the land must have been used predominantly, for most of the time the person owns the land, for a dwelling that was the main home of the person; or

    (b) For a person disposing of residential land as a trustee, the land must have been used predominantly, for most of the time the trustee owns the land, for a dwelling that was the main home of a beneficiary of the trust, and:

        (i) A principal settlor (i.e. a settlor whose settlements for the trust are the greatest or greatest equal, by market value, excluding services provided for less than market value, and excluding "no-strings attached" gifts to the trust meaning transfers of value providing that they are not made by one or a combination of: a beneficiary, a trustee, a person with power of appointment and removal of trustees, a person with a contingent interest in trust property, or a person who is a decision-maker under the trust) does not have a main home; or

        (ii) If a principal settlor has a main home, it is that main home that is being disposed of.

15. The main home exclusion does not apply to a person disposing of residential land if:

    (a) The exclusion has been used by the person twice or more during the 2 years immediately preceding the bright-line test for the residential land (this is consistent with the exception to the main home information exemption discussed in paragraph 9 onwards and in paragraph 18 in *Weekly Comment* 12 February 2016); or

    (b) The person has engaged in a regular pattern of acquiring and disposing of residential land.

16. "Main home" is defined in s. YA 1 (exactly as it is in s. 156A of the LTA discussed in paragraph 17 onwards in *Weekly Comment* 12 February 2016) as meaning, for a person, the dwelling:

    (a) That is mainly used as a residence by the person (a home); and

    (b) With which the person has the greatest connection, if they have more than 1 home.

17. Officials have made the following points in the Officials' Report:

    (a) In relation to the main home exemption generally:

        (i) The main home exemption is not a "one property" exemption – it will apply only when the property disposed of is actually used as a person's main home;

        (ii) The main home exception is intended to be based on a person's actual use of the property rather than their intended use of the property;

        (iii) The main home exemption does not allow a person to pick which of their properties they can treat as their main home - it actually needs to be their main home;

        (iv) The main home exception is only available where the owner resides in the property (or the beneficiary of the trust resides in the property);

        (v) There are some limited circumstances when the main home exception would be available for persons who at the time of sale do not live in New Zealand, for example, where a person left New Zealand shortly before selling but used the property as their main home while they were in New Zealand;

(b) In relation to the principal settlor test for a trust:

   (i) Excluding transfers of value (other than from beneficiaries, trustees etc.) from being settlements for the purpose of the 'principal settlor' definition should ensure that genuine gifts to a trust by family members will not remove the ability to claim the main home exception;

   (ii) The reference to "a" settlor means that where multiple people have provided equal value to the trust, all of them are treated as principal settlors;

   (iii) The requirement that if the principal settlor "has" a main home that is the home being disposed of, is meant to make it clear that the principal settlor does not have to own the home in order to have a main home – it could, for example, be rented by the principal settlor;

(c) In relation to a main home owned through a look-through company ("LTC"), the owner of the LTC is treated, under s. HB 1(4)(b), as the owner of residential land purchased by the LTC for the purposes of the main home exception.

18. A number of points are made in the TIB Item in relation to the main home exemption that are exactly the same as the points made in *Tax Information Bulletin* Vol. 27 No. 10, November 2015 in relation to the main home information exemption, discussed in paragraphs 20 to 24 of *Weekly Comment* 12 February 2016.

19. The exception can only apply in full or not at all, it does not apply on a proportionate basis - if a property is used less than 50 percent of the time as the main home of the person, then the main home exception will not apply.

20. Most of the examples provided in the TIB Item are a repeat of examples in *Tax Information Bulletin* Vol. 27 No. 10, November 2015, discussed in paragraph 25 of *Weekly Comment* 12 February 2016:

   (a) The holiday home example – example 2 from *Weekly Comment* 12 February 2016, where the main home exclusion is not available for a holiday home because it is not the property with which the owner has the greatest connection;

   (b) The apartment block on a single title – example 6 from *Weekly Comment* 12 February 2016, where the main home exemption is not available because the majority of the land was used as a rental property;

   (c) The city apartment bought as a second home – example 3 from *Weekly Comment* 12 February 2016, where the main home exemption is not available for a city apartment as it is not the home with which the owner has the greatest connection;

   (d) The country store with living quarters – example 9 from *Weekly Comment* 12 February 2016, for which the main home exemption is available because the living quarters comprise 55% of the property (although the business premises is not available because the business portion comprises only 45%);

   (e) A non-resident example is provided, where a person sells her New Zealand property 2 months after moving to the UK, and the main home exemption is available because she lived in the property for 10 months before going to the UK, which made it her main home for the majority of the time she owned it;

(f) A trusts student flat example is provided, where the main home exemption is not available for the sale by a trust of a student flat used as the home of the son of a principal settlor of the trust who owns another family home.

Deductions

21. For property that is liable for tax under the bright-line test, taxpayers will be able to deduct expenditure according to the ordinary tax rules.

22. Section DB 23(1) allows a deduction for the cost of revenue account property. Residential land to which s. CB 6A applies is "revenue account property", as defined in s. YA 1, because it is "property that, if disposed for valuable consideration, would produce income for the person …". Therefore, the cost of residential property to which s. CB 6A applies will be deductible under s. DB 23, subject to the timing rule in s. EA 2(2) – i.e. the income year in which the person disposes of the property.

23. The following points are made in the TIB Item:

(a) A person who sells property that is subject to the bright-line test will be allowed a deduction for the cost of the property at the time of sale.

(b) The cost of the property includes the amount that was paid to acquire the property (the initial acquisition price of the property), plus expenditure related to the acquisition such as the costs of lawyers, valuers, surveyors and real estate agents.

(c) The incidental costs of disposing of the property are also deductible as part of the cost of the property.

(d) The cost of the property also includes any capital improvements to the property made after acquisition, such as renovations.

(e) For holding costs, such as interest, insurance, rates and repairs, and maintenance expenses to be deductible as incurred, the holding costs must satisfy the normal deduction requirements – i.e. the holding costs must have a nexus with income and not be private in nature (or otherwise subject to any of the general limitations on deductions).

(f) For example, when the property is part of a business or profit-making undertaking or scheme, and there is no private use, or when the property is rented out, it is likely that the nexus would be satisfied.

(g) A deduction will be considered to be of a private nature if it is exclusively related to living as an individual, determined by the specific facts of any given situation – for example, if a person purchases a bach for family use, but sells the bach within two years, the holding costs would not be deductible because of the private limitation.

(h) Interest costs can automatically be deducted if the property is owned by a company (subject to some limitations).

Ring-fenced allocations of deductions for disposals of residential land within 2 years

24. Losses from deductions that are claimable solely against bright-line income (bright-line deductions) are ring-fenced, so they can only be offset against gains on other land sales that are taxable under any of the land sale provisions.

25. Specifically, the deductions allowed under s. DB 23 relating to residential land for which the person derives income solely under s. CB 6A are limited, under s. DB 18A, and deductions in excess of the limitation must be carried forward and can be used in a later year, subject to:

    (a) Meeting the deductions limit applying in the later year (s. DB 18A(4)); and

    (b) Meeting the shareholding continuity rules in s. IA 5 and IP 3 for the carry forward and use of tax losses in the case of companies (s. DB 18A(5)).

26. The limit applies to the sum of:

    (a) Deductions otherwise available under s. DB 23 relating to residential land for which the person derives income solely under s. CB 6A; and

    (b) Excess deductions from previous years carried forward under s. DB 18A(4).

27. The deduction limit for a person allocated to an income year is calculated as the sum of:

    (a) Income derived solely under s. CB 6A ("bright-line income"); and

    (b) Net income the person would have for the year if the only income they derived was from the disposal of land under ss. CB 6 to CB 14 ("land net income").

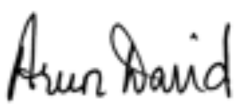
28. Note that if the residential land was acquired together with other property, an amendment to s. DB 29 means that the apportionment rule applies and the cost of acquisition must be apportioned between the land and the other property.

29. Officials stated in the Officials' Report that that holding costs for property subject to the bright-line are deductible according to ordinary tax rules. However, officials do not consider that current deductibility rules allow holding costs to be deductible for revenue account property when the property is used only for private purposes. Officials recognise there should be greater certainty on the deductibility of holding costs in relation to the land sale rules and other revenue account property generally, and intend to consider this area further.

30. Officials confirmed in the Officials' Report that losses from property sales that are also taxable under the current land sale rules (that is those that are not solely taxable under the bright-line test) will not be ring-fenced.

No group loss offsets for losses under the bright-line rule

31. Group companies will not be able to offset excess deductions or losses arising under the bright-line rule against any net taxable income from land sales in other group companies. Officials considered this would increase the complexity of the ring-fencing. Consolidated groups will be able to offset ring-fenced deductions against the land income from other consolidated companies.



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