CHARTERED ACCOUNTANTS
AUSTRALIA + NEW ZEALAND

DavidCo Limited
CHARTERED ACCOUNTANTS

Level 2, Shortland Chambers
70 Shortland Street, Auckland
PO Box 2380, Shortland Street
Auckland 1140
T +64 9 921 6885
F +64 9 921 6889
M +64 21 639 710
E arun.david@davidco.co.nz
W www.davidco.co.nz

WEEKLY COMMENT: FRIDAY 4 MARCH 2016

1. This week I complete 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) Deduction cap and no rollover relief on disposals to associated persons;

   (b) Residential land transferred upon a relationship property settlement;

   (c) Residential land transferred to an executor, administrator or beneficiary upon death;

   (d) Residential land transferred on a resident's restricted amalgamation;

   (e) Anti-avoidance rule when a company owns residential land;

   (f) Anti-avoidance rule when a trust owns residential land; and

   (g) Non-active trusts may be excused from filing returns.

Deduction cap and no rollover relief on disposals to associated persons

2. The deductions allowed under s. DB 23 of the *Income Tax Act 2007* relating to residential land for which the person derives income solely under s. CB 6A are capped, under s. DB 18AB, to the amount of income derived under s. CB 6A, if the land is disposed of to an associated person.

3. The excess deductions are treated, under s. DB 18AB(2), as expenditure that the associated person has in relation to acquiring the 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 they considered this would prevent genuine losses being denied permanently through transfers to associated persons.

4. An example in *Tax Information Bulletin* Vol. 28 No. 1 February 2016 ("the TIB Item") demonstrates this. A person acquires a property for $500k and sells the property to an associated person. The property had decreased in value to $400k at the time of sale to the associated person, so the cost that can be deducted from the selling price (of $400k) is limited to $400k. When the associated person subsequently sells the property to an unassociated third party, the deductible cost of the property to the associated person will be $500k – i.e. the cost of the property of $400k plus the $100k loss disallowed to the previous owner.

5. There is no rollover relief for a transfer to an associated person, as there is for relationship property transfers (for which there is rollover relief – see paragraph 7 onward below) and inheritances (for which there is a complete exemption – see paragraph 10 onwards below). This would include a transfer to a trust. Officials stated in the Officials' Report that if a person chooses to place their property into a trust or restructure for genuine commercial reasons

immediately after acquiring it, they will not have a tax liability as there will be no gain from the disposal.

6. Consistent with there being no rollover relief, the transferee is not treated as acquiring the property on the same date as the transferor – i.e. there is a new acquisition date for the transferee. Officials considered the rule would be simpler and in the case of a property that has made a genuine loss, having a longer bright-line period would be more taxpayer-friendly.

Residential land transferred upon a relationship property settlement

7. Rollover relief applies to a transfer of property under a relationship property agreement. The transferee is treated as having acquired the property on the original registration date and will be taxable under the bright-line test rules on any subsequent disposal that the rules apply to.
8. Specifically, when residential land is transferred on a "settlement of relationship property" (defined in s. FB 1(3) as a transaction between parties to a relationship agreement that creates a disposal and acquisition of property under subpart FB), s. FB 3A states, for the purposes of s. CB 6A, that:

   (a) The transfer is treated as a disposal by the transferor and an acquisition by the transferee at the cost of the residential land to the transferor at the date of the transfer; and

   (b) The date the transferee acquired the residential land is the relevant date for the transferor's acquisition under s. CB 6A(1)(a) or (b), being either the date on which the instrument to transfer the land to the transferor was registered in New Zealand or registered overseas in the case of land outside New Zealand or the transferor's "date of acquisition" of the land if the transfer to the transferor is not registered on or before the bright-line date (as discussed in *Weekly Comment* 19 February 2016 from paragraph 23 onwards).

9. This relationship property transfer rule applies to a person's disposal of residential land if the date that the transferor first acquires an estate or interest in the residential land is on or after 1 October 2015 (as discussed in *Weekly Comment* 19 February 2016 from paragraph 27 onwards). There is no full exemption –the transferee merely steps into the shoes of the transferor. Officials have stated in the Officials' Report that:

   (a) In most cases property subject to the bright-line would have been acquired during the relationship, which means it can be presumed that the two parties had a joint intention in acquiring the property; and

   (b) Unlike inheritance (for which there is a full exemption – see paragraph 10 onwards below), the parties have scope to negotiate the transfer of the property.

Residential land transferred to executor, administrator or beneficiary upon death

10. Transfers occurring upon the death of a person will not be subject to tax under the bright-line test. It is noted in the TIB Item that property that has been bequeathed or devised under a will may be gifted as a specific legacy, general legacy or residuary gift. Specific legacies are treated as taking effect from the date of death, so income arising from the property is derived by the beneficiary from the date of death. A general or residuary legacy vests in a beneficiary at the time of distribution. All such transfers and any subsequent transfer of the property by the beneficiary are exempt from tax under the bright-line test.

11. New s. FC 9 states that s. CB 6A (i.e. the bright-line test rules) does not apply when:

    (a) Residential land is transferred on a person's death to an executor or administrator (as per s. FC 1(1)(a)) or subsequently transferred on a distribution by an executor, administrator or trustee of the deceased estate to a beneficiary who is beneficially entitled to receive the property under the will or the rules governing intestacy (as per s. FC 1(1)(b)); and

    (b) Section FC 5 does not apply (s. FC 5 provides an exemption from ss. CB 9 to CB 11 and CB 14, all of which apply when land is disposed of within 10 years of acquisition, when land is transferred to an executor, administrator or beneficiary upon ta person's death, but transfers the cost of the land to the deceased person to the transferee if the land is sold within 10 years of its acquisition by the deceased person and income arises under any of ss. CB 9 to 11 or CB 14).

12. This means that the bright-line test rules do not apply to residential land transferred on a person's death to an executor or administrator, and subsequently transferred on a distribution by an executor, administrator or trustee of the deceased estate to a beneficiary who is beneficially entitled to receive the property under the will or the rules governing intestacy:

    (a) The basic rule, for residential land disposed of within 2 years will not apply; and

    (b) The bright-line test for subdivisions will not apply; and

    (c) The bright-line test for leases with a perpetual right of renewal will not apply; and

    (d) The bright-line test for contingent interests will not apply.

13. This is not "rollover relief" in the sense that term is used for relationship property transfers. The exemption applies even if the deceased would have been subject to tax under the bright-line test rules had they still been alive and subsequently disposed of the property themselves. The beneficiary (transferee) does not step into the shoes of the deceased in terms of the ownership of the property, and the date of the inheritance is not a "date of acquisition" for the beneficiary. A subsequent disposal of the land by the beneficiary is exempt from the bright-line test rules.

14. If the transferee disposes of the residential land and derives income (outside of the above exemptions – i.e. under the other land tax rules), the cost of the land to the transferee is the sum of:

    (a) The cost of the land to the deceased person; and

    (b) All other expenditure incurred by the transferee, the deceased person, or administrator or executor of the deceased person, for which no deduction has been allowed.

15. Section FC 9 overrides:

    (a) Section FC 3 (which provides that property transferred upon a person's death to a spouse, civil union partner or de facto partner, including any intervening transfer to an executor or administrator) is treated as a transfer of property under a settlement of relationship property under subpart FB; and

    (b) Section FC 4 (which provides that a transfer of tax-base property when the only beneficiaries are a close relative of the deceased person or a charity is treated as a transfer of relationship property if certain other requirements are met).

16. These rules on transfers upon the death of a person rule applies to a person's disposal of residential land if the date that the deceased person first acquires an estate or interest in the

residential land is on or after 1 October 2015 (as discussed in *Weekly Comment* 19 February 2016 from paragraph 27 onwards).

Residential land transferred on a resident's restricted amalgamation

17. Rollover relief is available for residential land transferred on a resident's restricted amalgamation. Section FO 17, which concerns transfers of land from an amalgamating company to the amalgamated company on a resident's restricted amalgamation has been amended to include the application of the 2-year bright-line test as follows:

    (a) If the land is not revenue account property of the amalgamating company, but a subsequent disposal of the land by the amalgamated company would give rise to income under any of the land taxation rules in s. CB 6A to CB 14 (i.e. including the bright-line test rules), the land is treated as disposed of by the amalgamating company to the amalgamated company at its market value on the date of the amalgamation;

    (b) If the land is revenue account property of the amalgamating company, but not because of the 2-year bright-line test or any of the 10-year rules, and the land would be, or may be, revenue account property of the amalgamated company under the 2-year bright-line test or any of the 10-year rules (i.e. under ss. CB 6A, CB 9 to CB 11, and CB 14), the land is treated as disposed of by the amalgamating company to the amalgamated company at its market value on the date of the amalgamation;

    (c) If the land is, or may be, revenue account property of the amalgamating company under the 2-year bright-line test or any of the 10-year rules (i.e. under ss. CB 6A, CB 9 to CB 11, and CB 14), and the amalgamated company disposes of the land within the relevant 2-year or 10-year period after the amalgamating company acquired it, the amalgamated company will derive the income under the applicable section.

Anti-avoidance rule when a company owns residential land

18. The anti-avoidance rule in s. GB 52 applies from 1 October 2015 when:

    (a) A company owns residential land directly or indirectly for which the acquisition date under s. CB 6A(1)(a) (i.e. the date of registration of the land transfer) or s. CB 6A(1)(b) (i.e. the "date of acquisition" if the transfer is not registered) is within 2 years of a disposal of shares that paragraph (c) below applies to (the "company residential land"); and

    (b) Residential land owned directly or indirectly by the company makes up 50% or more, by market value, of the assets of the company; and

    (c) 50% or more of the shares in the company, by market value, are disposed of within a 12-month period, with a purpose or effect of defeating the intent and application of s. CB 6A (i.e. the bright-line test rules).

19. The effect of the anti-avoidance rule, as set out in s. GB 52(2) is that, for each shareholder that disposed of shares:

    (a) The company is treated as disposing of a portion (the "shareholder portion") of the "company residential land " to the relevant shareholder for a consideration equal to the cost to the company of the portion; and

    (b) Re-acquiring the "shareholder portion" of the "company residential land" at market value (which adjusts the cost base of the land for the company); and

(c) The relevant shareholder is treated as having acquired the shareholder portion of the company residential land at the cost to the company and having sold it back to the company at its market value (this entitles shareholders to the deductions they would have had if they had sold the land themselves).

20. Each "shareholder portion" is calculated, under s. GB 52(3), as the proportion the market value of shares disposed of by the shareholder bears to the total market value of shares in the company.

21. Officials confirmed in the Officials' Report that when s. GB 52 applies, the bright-line test only applies to the properties that have been acquired within two years of the share disposal.

22. An example in the TIB Item demonstrates the application of this rule as follows:

(a) Two shareholders set up a company in which they each own 50% of the shares;

(b) The company buys residential land for $500k;

(c) Shareholder 1 sells all his shares to a third party within the 2-year bright-line period, at a time when the market value of the land has increased to $600k;

(d) The company is treated a having sold 50% of the residential land to shareholder 1 for $250k and shareholder 1 is treated as having sold the land back to the company for $300k;

(e) Shareholder 1 is treated as having made a taxable profit of $50k.

Anti-avoidance rule when a trust owns residential land

23. The anti-avoidance rule in s. GB 53 applies from 1 October 2015 when:

(a) The trustees of a trust own residential land directly or indirectly (the "trust residential land"): and

(b) The trust residential land makes up 50% or more, by market value, of the assets of the trust; and

(c) The trust's trust deed changes, a decision-maker under the trust deed changes, or an arrangement under the trust changes, with a purpose or effect of defeating the intent and application of s. CB 6A (i.e. the bright-line test rules).

24. If s. GB 53 applies as a result of a change described above, s. GB 53(2) states that the trustees are treated as disposing of the residential land affected by the change for an amount of consideration equal to the market value of the land at the time of the change.

Non-active trusts may be excused from filing returns

25. A new rule in s. 43B of the *Tax Administration Act 1994* ("the TAA") excuses a trust from filing a tax return in the following circumstances:

(a) Throughout the year the trust is a "non-active trust" and a complying trust as defined in s. HC 10 of the *Income Tax Act 2007*; and

(b) The trustee has filed a declaration in a form approved by the Commissioner that the trust is a non-active trust and that it will notify the Commissioner if it stops being a non-active trust; and

(c) The trust has not since the making of the declaration stopped being a non-active trust.

26. A trust is a non-active trust for a tax year if, throughout the tax year, the trustee:
    (a) Has not derived or been deemed to have derived any income; and
    (b) Has no deductions; and
    (c) Has not been a party to or perpetuated or continued with any transactions with assets of the trust which, during the tax year, give rise to income in any person's hands or give rise to fringe benefits to any employee or former employee.
27. For the purpose of determining whether the requirements to be a non-active trust have been complied with, the following are ignored:
    (a) Reasonable fees paid to a "professional trustee" (defined in s. 3(1) as a person whose profession, employment, or business is or includes acting as a trustee or investing money on behalf of others) to administer the trust; or
    (b) Bank charges or other minimal administration costs totalling not more than $200 in the tax year; or
    (c) Interest earned on trust assets in any bank account during the tax year, to the extent to which the total interest does not exceed $200; or
    (d) Insurance, rates and other expenditure incidental to the occupation of a dwelling owned by the trust and incurred by the beneficiaries of the trust.
28. Officials confirmed in the Officials' Report that distributions of capital by a complying trust will be allowed and a non-active trust is not restricted from disposing of its assets.
29. If the trust ceases to be a non-active trust the Commissioner must be notified.

Arun David, Director,
DavidCo Limited