Taxation (Bright-line Test for Residential Land) Bill

Officials' Report to the Finance and Expenditure Committee on Submissions on the Bill

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Bright-line test

OVERVIEW

The Taxation (Bright-line Test for Residential Land) Bill proposes a new objective "bright-line" test for disposals of residential land. The bright-line test will require income tax to be paid on any gains from residential property that is disposed of within two years of acquisition, subject to some exceptions. This measure was announced as part of Budget 2015.

The primary goal of the bright-line test is to create an easy to enforce rule to supplement the "intention" test in the current land sale rules. The intention test is difficult to enforce due to its subjectivity. The bright-line test is intended to supplement the intention test with an objective test.

Matters raised in submissions

Ten submissions were made on the bill.

Two submissions supported the bright-line test and four did not support it. Submissions in favour of the bright-line test submitted that the bright-line test appeared to be a reasonable addition to the current intention test, to ensure that property investors declare the income they are required to. Submitters who did not support the bright-line test believed the test to be unprincipled and likely to apply only to persons who are forced to sell due to circumstances outside of their control.

A number of submissions were received on the technical detail of the proposed design of the bright-line test.

There were five main areas of concern raised by submitters. These were:

- the start date for the bright-line period;
- additional exceptions to the bright-line;
- the deductibility of holding costs for property subject to the bright-line;
- ring-fencing losses; and
- the proposed land-rich company rule.

These submissions are explained in more detail in the report.

Matters raised by the Finance and Expenditure Committee

The Finance and Expenditure Committee asked officials for example scenarios to demonstrate how the bright-line test would work in practice.

The Committee also asked for further information on the provisions for inheritance in the bill and whether there were any changes planned to the current intention test as a result of the new bright-line test.

SUPPORT/OPPOSITION TO REFORM

Clauses 4 to 15

Issue: Support for bright-line test

Submission
(EY, PwC)

Two submitters supported the proposed bright-line test.

They stated that the bright-line test appeared to be a pragmatic approach to address concerns regarding enforcement of the intention test.

Recommendation

That the submission be noted.

Issue: Opposition to bright-line test

Submission
(Chartered Accountants Australia and New Zealand, New Zealand Law Society, nsaTax, KPMG)

Four submitters did not support the proposed bright-line test.

The reasons for this included:

- that instead of piecemeal change, problems with the land sale rules need to be looked at in a comprehensive manner;
- better enforcement of the existing rules would be preferable to the bright-line test;
- better enforcement should be possible with the better information available as a result of the Taxation (Land Information and Offshore Persons Information) Bill;
- the burden of proof already lies on the taxpayer to prove they did not purchase with an intention of resale;
- the bright-line test will only tax those who are forced to sell property due to circumstances outside their control;
- the proposal could lead to a proliferation of bright-line tests, for different asset classes, depending on the issue of the day; and
- speculators will change their behaviour to hold for longer than two years.

Comment

The goal of the bright-line test is to create an easy to enforce rule to supplement the "intention test" in the land sale rules. The rule is intended to address the difficulties that Inland Revenue has in enforcing this rule, particularly in relation to residential property because of its high volume and turnover.

We consider the bright-line test a pragmatic measure to address these difficulties.

Recommendation

That the submission be declined.

CHANGING BRIGHT-LINE TEST TO A REBUTTABLE PRESUMPTION

Clause 4

Submission
(Matter raised during oral submissions)

During oral submissions to the Committee it was suggested that the bright-line test could be changed to a rebuttable presumption that property acquired and disposed within two years was acquired with an intention of disposal.

Comment

The primary goal of the bright-line test is to provide an easy to enforce rule. This is due to difficulties in enforcing the current intention, test which is difficult to enforce because of its subjectivity and the ability for taxpayers to argue that they did not acquire property with an intention of resale.

We do not consider that designing the bright-line test as a rebuttable presumption of intention would achieve the goal of creating an easy to enforce rule. With a rebuttable presumption, taxpayers would still be able to argue that they did not have an intention of resale. As a result, this would be materially the same as existing law and contain the same subjectivity and enforcement difficulties.

Recommendation

That the submission be declined.

APPLYING BRIGHT-LINE TO OTHER ASSETS

Clauses 4 to 15

Submission
(New Zealand Property Investors' Federation Inc)

It is unfair that the bright-line test only applies to property investments. There should be a bright-line test for share or business traders.

Comment

The bright-line test is intended to address the problems of enforcing the land sale rules in the situation of high turnover of residential property.

Recommendation

That the submission be declined.

LEGISLATIVE COHERENCE

Clauses 4 to 15

Issue: Coherence of reforms

Submissions
(Chartered Accountants Australia and New Zealand, KPMG)

The bright-line test is the second of the three stages of reform package to the taxation of land (with the first being the recent information requirements in the Taxation (Land Information and Offshore Persons Information) Bill and the third being the proposed residential land withholding tax).

The Select Committee should undertake a review of the reforms included in the three bills to ensure that the reforms form a coherent whole. *(Chartered Accountants Australia and New Zealand)*

The coherence and consistency of the overall policy should be considered as part of the bill containing the residential land withholding tax. If necessary, remedial amendments for the first and second parts should be considered as part of that bill. *(KPMG)*

Comment

A post-implementation review is a recognised part of the generic tax policy process.

We consider that the bill containing the proposed residential land withholding tax will provide an opportunity to consider any amendments to the bright-line test that would assist in maintaining coherence with the other reforms.

Recommendation

That the submissions be noted.

Issue: Coherence with current land rules

Submission
(Chartered Accountants Australia and New Zealand)

The concepts underlying the bright-line test and the other reforms and the definitions relied on should be consistent with those in the current land rules.

Comment

In the design of the bright-line test we have used existing land rules where possible.

However, as submitters have noted there are some areas of departure for the bright-line test.

We consider that these areas of departure are necessary to ensure that the bright-line test meets its goal of being an easy to enforce rule.

For example, the current "residential exclusion" in section CB 16 is not fit for bright-line purposes. The existing "residential exclusion" is not limited to one property. A person may use the exception for both their main home as well as their bach or holiday house. In addition, a person can use trusts to obtain the "residential exclusion" a multitude of times for properties that the person does not live in.

Recommendation

That the submission be declined.

TIMEFRAME FOR SUBMISSIONS

Clauses 4 to 15

Submission
(New Zealand Law Society)

The period for making submission should be extended so that proper consideration can be given to the proposed reforms.

Comment

The bright-line test is intended to apply to land acquired and disposed after 1 October 2015. A longer submission period would result in enactment being delayed and the degree of retrospectivity of the bill would increase.

Recommendation

That the submission be declined.

ALTERNATIVE DESIGN OF BRIGHT-LINE TEST

Clauses 4 to 15

Submission
(Chartered Accountants Australia and New Zealand, EY)

The Government could achieve its key policy objective of supplementing the "intention test" more simply and coherently by amending section CB 6. This could provide that when any land is disposed of within two years of acquisition that land is treated as if it were acquired with the purpose or intention of disposing of it.

Differences between the proposed bright-line test and the current land sale rules are likely to increase uncertainty and cause confusion. Instead, the current rules regarding section CB 6 and intention should be used.

Comment

The proposed design differs from the current design in many ways. This includes the scope of land that the bright-line test applies to as well as other areas such as the ability to claim losses.

For the reasons outlined we believe that the design of these features needs to be different from the intention test. Generally this is to ensure that the bright-line test meets its goal of being an easy to enforce rule.

For example, as outlined for *Issue: Coherence with current land rules*, the current rules regarding the "residential exclusion" are not fit for purpose and can result in a person obtaining the main home exception multiple times.

Recommendation

That the submission be declined.

ORDER AND STATUS OF PROPOSED SECTION CB 6A

Clause 4

Issue: Ordering of sections

Submission
(Chartered Accountants Australia and New Zealand, PwC)

The proposed section CB 6A supplements section CB 6 and, as a result, should follow rather than precede it.

Furthermore, positioning an inserted section "CB 6A" before section CB 6 seems to go against the numbering convention normally followed in the tax legislation.

Comment

The position of section CB 6A provides greater clarity in how the existing provisions relating to the land sale rules apply to the bright-line. Where existing provisions currently refer to section "CB 6 to CB 14" it will be clear whether they are intended to apply to the bright-line as they will instead refer to section "CB 6A to CB 14".

The correct numbering convention for tax bills is being followed by placing section CB 6A before section CB 6.

Recommendation

That the submission be declined.

Issue: Status of section CB 6A

Submission
(nsaTax, EY)

Section CB 6A should apply only when other provisions taxing land transactions do not apply. The current approach can result in uncertainty.

For example, if both section CB 6A or section CB 12 could both apply, it is unclear whether the main home exclusion would exempt them from tax. In that circumstance it should be section CB 12 that applies.

It would also be unclear what the result would be for sections DB 27 or DB 28 or whether the ring-fencing applies if more than one land provisions applies.

As a precedent note that sections CB 13 and CB 14 are expressed as applying only if a taxpayer's land disposal is not taxed under any of sections CB 6 to CB 12.

Comment

We agree that the relative priority of the bright-line test in the land sale rules should be clarified.

Recommendation

That the submission be accepted.

YEAR INCOME DERIVED UNDER BRIGHT-LINE

Clause 4

Issue: Income year bright-line income derived

Submission
(EY)

Proposed section CB 6A includes a specific definition of "date of disposal". The use of this term may suggest that income is to be derived at the date of disposal rather than at the date of settlement.

Confirmation is required that the income year in which any bright-line rule income is regarded as derived for income tax purposes will generally be the income year in which the transaction is settled, in accordance with general principles relating to income derivation from the land sales, and will not be determined by the "date of disposal" as proposed to be defined for bright-line purposes.

There should be express confirmation that the general timing rules are intended to apply.

Comment

Income taxable under the bright-line rule is intended to be recognised in the year in which it is derived under general principles rather than solely by the "date of disposal".

We propose to change the term "date of disposal" to remove any doubt. We will also clarify this in the *Tax Information Bulletin.*

Recommendation

That the submission be accepted.

Issue: Use of term "date of disposal"

Submission
(EY)

The use of the term "date of disposal" may cause confusion for the reasons outlined by the previous submission. It should be replaced with words along the lines of "bright-line period date" or something similar. This ensures the distinction between characterisation of a transaction as taxable and the timing of recognition of that income.

Comment

We agree with the submission.

Recommendation

That the submission be accepted.

Issue: Specific allocation rules and express provision against possibility of double taxation

Submission
(EY)

If income which is taxable under the bright-line rule is intended to be recognised in the year of the "date of disposal", a specific allocation rule should be expressly included in the legislation and there should be express rules to prevent double taxation if it is also taxable in a later year under another of the land sale rules.

Comment

Income taxable under the bright-line rule is intended to be recognised in the year in which it is derived under general principles rather than solely by the "date of disposal".

Recommendation

That the submission be declined.

Clause 4

Issue: Limit to property situated in New Zealand

Submissions
(Deloitte, Chartered Accountants Australia and New Zealand)

The bright-line test should not apply to property situated outside of New Zealand.

Covering property outside of New Zealand goes beyond the scope of the bright-line bill which is to address high turnover in the New Zealand residential property market. It would also require additional resources from Inland Revenue to track overseas transactions.

Existing provisions sufficiently cover overseas property owned by New Zealand residents.

It should not be assumed that the land registration system in overseas jurisdictions is as accurate and reliable as the New Zealand land transfer system. *(Chartered Accountants Australia and New Zealand)*

Comment

New Zealand residents are taxed on their worldwide income. It would be inconsistent with this general principle for New Zealand residents to be taxed only on their New Zealand land sales.

The bright-line test is intended to supplement the intention test in the land sale rules which already applies to properties situated outside of New Zealand. As a result, we consider that the bright-line test should apply to properties situated outside of New Zealand when they fall within the bright-line period.

Recommendation

That the submissions be declined.

Issue: Claiming foreign tax credits

Submission
(Deloitte, Chartered Accountants Australia and New Zealand)

Applying the bright-line test to foreign land risks creating double taxation where a foreign jurisdiction applies a capital gains tax to the same sale of land.

New Zealand domestic law and our double tax agreements are unlikely to provide for a foreign tax credit for capital gains tax paid on overseas land.

If the submission to limit the application of these rules to land in New Zealand is not accepted, the international tax issues should be given further consideration and it should be clarified that foreign tax credits are available. *(Deloitte)*

Comment

The normal foreign tax credit rules will apply to foreign land subject to the bright-line test. Therefore if sellers satisfy the existing foreign tax credit requirements they will receive a foreign tax credit.

These tax credit rules apply to sales that fall within the existing land sale rules. We would not want to give preferential treatment to sales that are made within the bright-line period.

The transitional residence rules also reduce the scope of this issue for new migrants. Under these rules, new migrants are not taxed on their foreign-sourced income.

Recommendation

That the submission be declined.

Issue: Non-resident foreign-sourced income

Submission
(Deloitte)

The bright-line should not apply to land outside of New Zealand that is purchased and sold by non-residents as this should fall within "non-residents' foreign-sourced income", as defined under existing section BD 1(4) of the Income Tax Act 2007.

Comment

New Zealand does not tax non-residents on their foreign-sourced income under section BD 1(4). This section will mean that the bright-line test will not apply to overseas land sold by a non-resident.

Recommendation

That the submission be noted.

TWO-YEAR PERIOD

Clauses 4, 15(2), (3) and (4)

Issue: Start date for two-year period

Submission

(Chartered Accountants Australia and New Zealand, nsaTax, New Zealand Law Society, PwC, Chapman Tripp, KPMG)

Several submitters proposed that the start date for the two-year bright-line period should be the date that a person enters into an agreement to purchase the land rather than the date they obtain registered title to the land.

The reasons given for this included:

- the current land sale rules regard the acquisition date as the date a person enters into an agreement to purchase the land. The start date for the bright-line period should be consistent with this;
- using the date of registration unfairly shortens the bright-line period;
- using the date a person enters into a contract to purchase land as the start date would minimise the number of sales purchased without an intention of resale;
- it would be fairer for the start date of the bright-line test to be consistent with the end date for the bright-line test;
- there would be no difficulty for taxpayers in determining the start date as they are required to keep documentation of this and know it for the purposes of the other land sale rules;
- using it as the start date would mean that there does not need to be a separate rule for sales "off the plan";
- it better reflects that people are committed to buying the property from the date they enter into an agreement for sale and purchase; and
- using the registration date is a policy reversal from the section CB 15B approach enacted in 2014.

Comment

The bright-line test is intended to be an objective, easy to enforce rule. To achieve this, the start date for the bright-line test needs to be a recorded, verifiable date. A recorded, verifiable date would also make the proposed withholding tax easier to apply.

The only date recorded on Landonline is the registration date. As a result the registration date needs to be the start date for the bright-line test. We consider that for the majority of people, having a separate date for the bright-line test from the other land sale rules will not cause significant difficulty.

Recommendation

That the submission be declined.

Issue: Sales "off the plan"

Submission
(PwC, Deloitte)

The proposed separate rule for sales "off the plan" can lead to outcomes that are unduly harsh and the application of the bright-line test is likely to be misunderstood by taxpayers.

Take the following situation:

1 July 2016: Person enters into a contract to purchase

1 September 2018: Person obtains registered title

1 March 2019: Person enters into contract to sell

In this situation the person will be captured by the proposed bright-line rule because they entered into a contract to sell (1 March 2019) within two years of obtaining registered title (1 September 2018).

In contrast, if the person had entered into a contract to sell on 1 August 2018, they would not be covered by the proposed bright-line rule because they entered into a contract to sell (1 August 2018) more than two years after entering into a contract to purchase (1 July 2016).

Comment

We agree that the situation outlined by the submitter would be anomalous.

To resolve this we propose amending the start date in the circumstances when a person has a sale "off the plan" which they later obtain registered title to.

In this circumstance we propose that the person would be able to start the two-year period at the date they entered into a contract to purchase the property.

In the scenario outlined by the submitter, the proposed amendment would mean the bright-line period would start from 1 July 2016. The sale on 1 March 2019 would not be covered by the bright-line test.

Recommendation

That the submission be accepted.

Issue: Reducing two-year period

Submission
(New Zealand Property Investors' Federation Inc)

The bright-line test is intended to make gains from speculators taxable. It is not intended to capture gains from property investors that purchase property to use as rental property.

The bill should send a message to the general public that rental property is not intended to be captured by the test by reducing it to one year or eighteen months. This would prevent some rental property owners from unintentionally being caught by the new test, but would still capture the traders that the test is actually intended for.

Comment

The period of the bright-line test is intended to balance the need provide an easier to enforce rule to target short-term speculation while minimising the number of sales made taxable that were acquired without an intention of resale.

We consider that the two-year period best meets these competing objectives. It creates an easy to enforce rule to address the key difficult of enforcement where there is a high turnover of properties.

Recommendation

That the submission be declined.

Issue: Start date for third-party nominations

Submission
(nsaTax)

The bill does not adequately cover the circumstance where the purchaser of a property nominates another third-party person to be the purchaser under a Deed of Nomination.

The nominees in these situations may not be in any way privy to the transaction when the sale and purchase agreement is entered into. Furthermore, the nominee may not even have been in existence at the time the agreement is entered into. The acquisition date should be consistent with other taxing provisions and existing law that is the date the "first interest" in the property is acquired being the date of the Deed of Nomination in the case of nominations if the "nominator" has already acquired their "first interest" in the property.

Comment

In the situation of a third-party nomination the result would be the same as under a sale of the 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). If they enter a Deed of Nomination, they are transferring this interest (the right to buy the land) to another party.

Under the bill, the start date of the bright-line for this person is the date the person entered into the contract to purchase the land. This is the correct result because the "date of acquisition" in the bill is the latest date in which they acquired an interest in the residential land. For this person the latest date they acquired the interest is the date they entered into the contract to purchase.

The end date of the bright-line would be the date they entered into a deed of nomination. This is the result as the "date of disposal" is the date that the person entered into an agreement for the disposal. The Deed of Nomination is an agreement for the disposal of the land.

Therefore, we think the current bill adequately caters for nominations.

We intend to clarify this in the *Tax Information Bulletin*.

Recommendation

That the submission be declined.

Issue: Start date for associated-party nominations

Submission
(nsaTax)

The bill does not adequately cover the circumstance when the purchaser of a property nominates an associated person to be the purchaser under a Deed of Nomination.

This acquisition date should be the date the purchaser acquires their "first interest" in the property, which is the date the contract to purchase is entered into.

Comment

No rollover relief is proposed for transfers of property to associated persons (see *Issue: Rollover relief for associated persons*).

As a result the start date for associated-party nominations would be the same as for third-party nominations.

Recommendation

That the submission be declined.

Issue: Clarification required for "date of acquisition"

Submission
(EY)

Clarification is required of the intended meaning of the latest date on which a person acquires an estate or interest in the land. Given the broad definitions for income tax purposes of the "estate" or "interest" in relation to land and the use of the indefinite article, it does not seem to make sense to refer to a "latest date" for acquiring any such interest. A particular estate or interest will be acquired at a single particular date, not at a number of successive dates.

If the "latest date" is intended to refer to the date on which the last action required to complete or perfect a person's title occurs, we consider the wording should be revised to that effect. If it is intended to refer to the date when a person acquired the particular estate or interest, the disposal of which is in question, we suggest the reference should be to the date of acquiring that particular estate or interest.

Comment

We agree that the wording could be clarified by referring to the date of acquiring that particular estate or interest.

However we consider that 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.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Clarification for Land Transfer Act reference

Submission
(EY)

Clarification would be desirable on whether the reference to "if the land is not registered as described" in proposed section CB 6A(1) should be to the instrument of transfer of the land in this regard, rather than to the land itself.

Comment

We agree with the submission.

Recommendation

That the submission be accepted.

Issue: Subdivided land

Submission
(EY)

Proposed section CB 6A(2) refers to disposals of residential land that result "from the person subdividing other land". To make clear that this applies when that other land is not already "residential land" the words "whether or not that land is residential land" should be added.

Comment

"Residential land" and "land" are both specifically defined terms. Where the section uses the term "land" and not "residential land" we believe it is clear that the wider definition of "land" applies.

Recommendation

That the submission be declined.

RESIDENTIAL LAND

Clause 15(5), (7) and (11)

Issue: Bare land

Submission
(Chartered Accountants Australia and New Zealand, PwC, KPMG)

The definition of "residential land" should be changed to refer to "land that is zoned residential" or "land that is zoned for residential purposes" rather than land that "because of its area and nature is capable of having a dwelling erected on it".

The current definition is too vague and difficult to apply. In addition, most bare land would appear to meet this test.

Comment

We agree that the definition could be improved by referring to zoning rules rather than the area and nature of the land.

Recommendation

That the submission be accepted, subject to officials' comment.

Issue: Farmland

Submissions
(Chartered Accountants Australia and New Zealand, New Zealand Law Society, KPMG)

Lifestyle blocks should be eligible for the farming exclusion. This is consistent with the current taxing rules which treat small farm ventures as businesses. *(Chartered Accountants Australia and New Zealand)*

The proposed definition of farmland is not appropriate for the bright-line test. The current definition is uncertain and many farms currently would not earn sufficient income to meet the test. If officials' main concern is to exclude hobby farms and lifestyle blocks, then it should be defined by reference to that rather than using this definition. *(New Zealand Law Society)*

If the current definition of farmland is retained, there should be further guidance provided in the *Tax Information Bulletin*. *(New Zealand Law Society)*

In practice this may be a difficult test for many farms as they may not, initially at least, provide a return sufficient to cover all of the costs. To prevent confusion,

farmland should be defined simply as "land that is capable of being worked on as a farming or agricultural business". *(KPMG)*

Comment

Genuine farming businesses should be able to utilise the farmland exception even if they may have had a few bad years.

We consider that farmland could be defined more simply by removing the concept of an economic unit and instead defining it as "land that is capable of being worked on as a farming or agricultural business".

We also consider that the definition of farmland should be amended to ensure that the exception is available when a person may be running a farming business on several plots of land, but the individual plot of land they own is not of itself capable of being used for a farming business.

This situation could arise in the following example. A farmer owns a small plot of land that they run a farm on. The plot of land by itself is too small to be capable of being worked on as a farming business. However, the farmer is able to run a successful farming business on the land because the farmer's neighbours allow the farmer to use their land for the business.

This farmer would not be able to use the current farming exclusion because the land they own is not capable of being worked on as a farming business even though they are actually running a successful farming business on it.

To resolve this we consider that the farmland exclusion be available where the owner of the land uses the land for a farming business.

Recommendation

That the submission be accepted.

Issue: Residential leases

Submission
(Chartered Accountants Australia and New Zealand, KPMG)

It appears that the bright-line could apply on the termination (that is expiry) of a short-term lease.

The Commissioner's draft statement *(PUB0219: Income Tax – Whether the cost of acquiring an option is part of the cost of acquiring revenue account land)* states that the termination of an option over land is a disposal of that interest in land for the purposes of the land rule. The logical consequence of this position is that the termination of a lease is a disposal of an interest in land.

A specific exclusion is required in the legislation to ensure that the bright-line test does not apply on the disposal or termination of a lease of residential land.

Comment

We do not agree that the expiry of a lease is a disposal of the lease. This was not stated in draft *PUB0219*. As a result we do not consider the proposed amendment is necessary.

Recommendation

That the submission be declined.

Issue: Extent of land that is "business premises"

Submission
(EY)

It should be clarified that the reference to business premises is not intended to be restricted to buildings or to buildings and their immediate surrounding land.

The Commissioner of Inland Revenue's recent draft item, *PUB00201* says that "premises" is difficult to interpret and can have different meanings depending on the context.

Comment

We 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. This is similar to what was concluded in *PUB00201*.

We 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.

Recommendation

That the submission be declined.

Issue: Use of business premises or farmland by transferor

Submission
(EY)

It should be clarified that the business premises or farmland does not need to be used for a farming or agricultural business by the transferor to use the exception.

Comment

The proposed business premises and farmland exclusion (as presently drafted) requires the land be used predominantly as business premises or farmland. It does not require the land to be used as business premises or farmland by the transferor.

Recommendation

That the submission be declined.

Issue: Land used for rental purposes

Submission
(EY)

It should be clarified that "business premises" may include land used for rental purposes (whether residential or commercial) if the transferor's rental activities constituted the carrying on of a business rather than a passive investment.

The treatment of serviced apartments, in particular, should be clarified.

Comment

To obtain the business premises exclusion, the relevant land must be used predominantly as business premises.

The business premises exclusion is intended to be available if the land is rented out to a third party who occupies the land as their business premises. It is not intended to apply when it is rented out to a third party who occupies the land for residential purposes.

We 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.

Recommendation

That the submission be declined.

Issue: Extending bright-line to all land

Submission
(Matter raised during oral submissions)

During oral submissions it was suggested that the bright-line test could apply to all land rather than being restricted to residential land.

Comment

The bright-line test is targeted towards the particular problems of enforcing the current land sale rules in relation to residential land. Residential land causes particular difficulties for enforcement as there is a high volume and turnover of transactions. These difficulties are not evident to the same extent with other land.

Recommendation

That the submission be declined.

MAIN HOME

Clauses 6, 15(5), (10) and (11)

Issue: Alignment with current residential exclusion

Submission
(KPMG, EY)

The principal residence exemption in section CB 16 should be used instead of the proposed main home exception. This would align it with the intention test the bright-line test is intended to supplement, and remove uncertainty. *(KPMG)*

The scope of application of the "main home" exclusion in relation to trusts differs from those in the section CB 16 residential exclusion, and is more complicated to understand and apply. This should be simplified, if not aligned with the section CB 16 provision. *(EY)*

Comment

The "residential exclusion" in section CB 16 does not fit the policy of the bright-line test. The resident exclusion is not limited to one property. A person may use the exception for both their main home as well as their bach or holiday house. In addition, a person can use trusts to obtain the residential exclusion a multitude of times for properties that the person does not live in.

It is the policy intent that a person can only use the main home exception in the bright-line test for one property at a time. As a result, the proposed main home exception in the bright-line test differs from the current residential exclusion as it can only be used for one property at a time.

Recommendation

That the submission be declined.

Issue: Lifestyle blocks

Submission
(Chartered Accountants Australia and New Zealand, nsaTax)

If the submission to include lifestyle blocks within the farmland exclusion is not accepted, it should be made clear in guidance that the main home exclusion can be applied in appropriate circumstances to lifestyle blocks that are ineligible for the farmland exclusion. *(Chartered Accountants Australia and New Zealand)*

The main home exclusion should be clarified to ensure that lifestyle blocks are covered by the proposed exclusion. The vast majority of lifestyle blocks are not likely to meet the farmland exclusion. *(nsaTax)*

Comment

In some circumstances lifestyle blocks will be eligible for the main home exclusion.

An example of this is provided in this Officials' Report (*Example Scenarios*). Further examples are also available in the special report published at www.taxpolicy.ird.govt.nz for the recent Land Transfer Amendment Act 2015. We will also provide additional guidance in the *Tax Information Bulletin* for this bill after enactment.

Recommendation

That the submission be noted.

Issue: Legislatively detailing main home exception

Submission
(Chartered Accountants Australia and New Zealand, New Zealand Law Society, EY, KPMG)

Several submissions were received stating that specific features of the main home exception should be legislatively detailed.

In particular, submitters stated that the factors determining a person's "greatest connection" should be legislatively defined as the term is uncertain and the outline of them in the commentary to the bill and *Tax Information Bulletin* do not have determinative status.

Submissions were also received seeking legislative clarification of the treatment of co-owners and legislative reflection of how the main home exclusion is shown to apply in circumstances outlined in the commentary (for example, page 13 of the commentary outlining when the main home may be used for two properties at the same time).

Comment

Provisions such as the main home exception will apply in a wide number of circumstances and living arrangements.

It is neither feasible nor desirable for the legislation to prescribe every possible situation. Trying to provide detailed rules for every situation can lead to the legislation not applying appropriately.

Instead we prefer to apply general rules and provide guidance on how they work.

Recommendation

That the submission be declined.

Issue: Detailed guidance required

Submission
(Chartered Accountants Australia and New Zealand, New Zealand Law Society, KPMG)

There are several areas that are unclear about how the main home test will apply. Detailed guidance is required on how a person is to determine whether they are able to rely on the main home exclusion.

The commentary to the bill notes that in determining a person's greatest connection that the factors used to determine a person's "permanent place of abode" could be used. Case law indicates that this may be difficult to apply in practice.

Comment

We will provide guidance in the *Tax Information Bulletin* for the main home exception. In addition, Inland Revenue is providing additional guidance on the application of "greatest connection" for the recent changes in the Land Transfer Amendment Act.

Recommendation

That the submission be noted.

Issue: Habitual seller rule

Submission

(Chartered Accountants Australia and New Zealand, nsaTax)

The bill proposes that the main home exception is not available if the person has used the exclusion two or more times within the two years immediately preceding the date of disposal.

Explicitly allowing a person to rely on the main home exclusion twice in a two-year period sends the wrong message as people may assume they can sell two homes within each period of two years (and by implication many more homes over a longer period) and not be subject to tax on any gains on the sale of those properties. *(Chartered Accountants Australia and New Zealand)*

The main home exclusion should only be able to be relied on once in any two-year period. *(nsaTax)*

Comment

We agree that the proposed "habitual seller" rule for the bright-line test could send the wrong message.

The rule could lead to people assuming that their sale of their main home is non-taxable if they have not previously used the main home exception within the previous two years even if they have sold more properties over a longer period. This would be incorrect as the person may be taxable under the "intention" test and the habitual seller rule contained within the "intention" test.

To resolve this we consider that the main home exception for the bright-line should also not be available if a person has engaged in a regular pattern of acquiring and disposing of residential land. This is aligned with the existing habitual seller exception in the main residence exclusion to the "intention" test.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Principal settlor rule does not work appropriately in all circumstances

Submission

(Chartered Accountants Australia and New Zealand)

The "principal settlor" rule does not work appropriately in all circumstances, with the result that the main home exclusion will not be available in some circumstances when it should be.

Take, for example, where a 25-year old and her partner settle a trust which acquires their first home for $800,000. The couple are beneficiaries of the trust. As the couple only has $10,000 towards a deposit for the property, the 25-year old's mother lends $200,000 interest-free to the trust. That loan makes the mother a settlor of the trust. This scenario is common in practice.

If the interest foregone by the mother exceeds the settlement made by the 25-year old and her partner, the mother will be the principal settlor.

If the mother has her own main home, the couple will not be able to rely on the main home exclusion, even though the property was their main home.

Comment

We agree that the principal settlor provision would not work appropriately in the circumstances outlined by the submitter.

To fix this we recommend that a person is not a principal settlor for the purposes of the rule if they have provided value to a trust and they are neither a trustee of the trust, a beneficiary of the trust, a person with the power to appoint or remove trustees, or a decision-maker under the trust deed.

We consider this will ensure that genuine gifts to a trust by family members will not remove the ability to claim the main home exception, while still ensuring that the trust provisions cannot be used to claim the main home exception multiple times.

Recommendation

That the submission be accepted.

Issue: What transfers of value are counted for determining a principal settlor

Submission
(nsaTax, New Zealand Law Society, EY)

The "principal settlor" definition should be modified to take into account all settlements made and not be limited to property settled on the trust. It is common for value to be provided to a trust through debt forgiveness and providing free services to a trust. *(nsaTax)*

The definition of "settlor" includes a person making non-monetary transfers of value such as guaranteeing the trust's financial obligations and providing services at below-market value. In practice it may be difficult to value these non-monetary settlements. Inland Revenue should provide guidance on how to determine the "principal settlor" when non-monetary settlements are made on a trust. *(New Zealand Law Society)*

Clarification of the "principal settlor" definition is needed. *(EY)*

Comment

It is not clear what transfers of value are counted for determining the principal settlor. This can be seen by submitters having different views on what is counted for the purposes of this provision.

We consider this has arisen because the "principal settlor" definition looks at how much "property" has been settled in the trusts. What transfers would count as "property" is unclear.

We recommend clarifying this provision by having the principal settlor definition consider all transfers of value to the trust except transfers that are the provision of services at below market value. We believe this will provide greater certainty in the section. This approach is consistent with that used for defining a settlor for the purposes of the associated person definitions.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Use of term "value"

Submission
(nsaTax)

The use of the term "value" is unclear. It is assumed that this is meant to be market value. If so this should be made clear.

Comment

The term "value" is meant to refer to market value. We agree this should be made clear.

Recommendation

That the submission be accepted.

Issue: Multiple principal settlors

Submission
(Chartered Accountants Australia and New Zealand, nsaTax)

Where multiple people have provided equal value to a trust, it is unclear which of them is principal settlor.

We assume that neither of them will be for the purposes of section CB 16A. *(Chartered Accountants Australia and New Zealand)*

Comment

Where multiple people have provided equal value to the trust, it is intended that all of them are treated as principal settlors.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Focus on ownership

Submission
(nsaTax)

The main home exclusions should focus on both ownership and use of the relevant property. Currently, the proposed legislation focuses solely on use. The main home should be the one dwelling which is owned by the relevant vendor.

A person could have a rental property that they reside in which is their main home. This would mean that a separate property that they own would not be able to utilise the main home exception.

Comment

The main home exception is not intended to be a rule that enables all people to have one property exempted. It is intended to only apply when the property disposed of is actually used as a person's main home.

Recommendation

That the submission be declined.

Issue: Communal land

Submission
(nsaTax)

Many subdivisions include both residential lots and a single communal or amenities block. Typically, a purchaser will acquire a "normal" residential lot to build a dwelling on it together with an interest in a communal or amenities block. Most often, the area of the communal lot will far exceed the area of the residential lot.

The legislation should be amended to include within the main home exclusion direct or indirect interests in such communal land, which are required to be conveyed as part of a residential lot sale.

Comment

In most situations, communal areas will be part of the title of the land that is being transferred. In a circumstance when it is not part of the title being transferred, the communal land will likely not be residential land and therefore will not be covered by the proposed bright-line test. In addition, the communal land would have zero value (and therefore no gains to be made) as the land is worth nothing separate from the residential lot.

As a result we consider that the proposed amendment would add additional complexity to the legislation for no gain.

Part of the generic tax policy process involves a post-implementation review. We will monitor this area to ensure the bright-line test is working as intended.

Recommendation

That the submission be declined.

Issue: Use of home by family members

Submission
(EY)

The main home exclusion should apply where an owner's family members live there but the legal owners do not.

When a property is being used as a home for members of an owner's family, even if the owner is residing elsewhere there is no reasonable policy basis for not allowing the main home exception to apply.

Comment

It is intended that the main home exception is only available where the owner resides in the property (or the beneficiary of the trust resides in the property). This is consistent with the residential exclusion in the existing land sale rules.

Recommendation

That the submission be declined.

Issue: Look-through companies

Submission
(EY)

There should be clarification or confirmation that section HB 1(4)(b) would apply to treat the owners of look-through companies which own residential land as the relevant owners and persons for the purpose of the main home exception.

Comment

Section HB 1(4)(b) would have the effect of treating the owner of a look-through company as the owner of residential land purchased by the look-through company for the purposes of the main home exception. We will note this in the *Tax Information Bulletin*.

Recommendation

That the submission be noted.

Issue: Broader main home exception

Submission
(EY)

A broader main home exception should be available to cover "sales off the plan" when people intend to use the property as their main home. This approach would be consistent with the desired outcome intended by the changes to the date of acquisition made in 2014.

Comment

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. We believe expanding the main home exception would make it more subjective and difficult to enforce.

Recommendation

That the submission be declined.

Issue: Use of main home exception by non-residents

Submission
(EY, KPMG)

The commentary to the bill asserted that the main home exception cannot be used "if the owner of a property does not reside in New Zealand". There may be situations in which a person who does not live in New Zealand all the time could use the main home exception.

If it is intended that non-residents are unable to use the main home exception, express, detailed amendments to that effect are needed.

Comment

We agree 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. This could happen where a person left New Zealand shortly before selling but used the property as their main home while they were in New Zealand.

We will clarify this point in the *Tax Information Bulletin*.

Recommendation

That the submission be noted.

Issue: Practical difficulty in applying principal settlor test

Submission
(KPMG)

The principal settlor rule may be difficult to apply in practice where the trustee is independent of the settlor.

The settlor may also wish to claim the main home exemption in respect of property owned by the trust, rather than property the settlor may be residing in. At present the wording deems the main home exemption to apply to the settlor's other property, regardless of whether they wish for that property to be their main home.

Comment

The provision in the bill is consistent with the settlor-focused rules in the trust rules.

The main home exception does not allow a person to pick which of their properties they can treat as their main home. If a person wishes to claim the main home exemption in respect of property, it actually needs to be their main home.

Recommendation

That the submission be noted.

Issue: Principal settlor who has a main home that they do not own

Submission
(Matter raised by officials)

There is a gap in the "principal settlor" provision which can lead to a person being able to access the main home exception multiple times through the use of trusts.

This occurs because proposed section CB 16A(1)(b)(ii) only denies the main home exception when the principal settlor of the trust does not *own* a main home.

A person could work around this rule by ensuring that they do not *own* their main home and instead rent their main home. The person could then place their properties in trust and use the main home exception for multiple properties without the principal settlor restrictions.

Comment

The principal settlor provisions are intended to ensure that people cannot use the main home exception multiple times through the use of trusts.

We consider that this gap should be closed. This could be remedied by changing the requirement that the principal settlor "own" a main home to a requirement that they "have" a main home.

Recommendation

That the submission be accepted.

INHERITED PROPERTY

Clauses 4(3) and 11

Issue: Drafting of “cost of residential land”

Submission
(New Zealand Law Society)

The drafting of the inheritance rollover includes in the value of the land being rolled over expenditure that does not relate to the land as well as expenditure on revenue account.

The drafting should be clarified so that the expenditure must relate to the subject land and only expenditure of a capital nature is included.

Comment

The drafting of “cost of residential land” is consistent with the current land rules for inheritance. We expect that the same interpretation would be applied for both.

Recommendation

That the submission be declined.

Issue: Redrafting inheritance provision

Submission
(EY)

Proposed new sections CB 6A(3) and FC 9 are not appropriate to achieve the intended outcome.

The simpler approach would be to amend section CB 6A(3) to include a reference to transfers to a deceased’s personal representatives as described in section FC 1(1)(a) as well as to disposals made by personal representatives as described in section FC 1(1)(a), as well as to disposals made by such personal representatives and disposals by beneficiaries who receive residential land by inheritance under a will or on intestacy.

Comment

Subpart FC contains the provisions dealing with inheritance. We consider that including the inheritance provisions for the bright-line test within subpart FC is more consistent with the scheme of the Income Tax Act.

We also consider that moving away from this scheme would result in unintended consequences.

Recommendation

That the submission be declined.

Issue: Alignment with other provisions in subpart FC

Submission
(EY)

If the above submission is not accepted, the interaction of all of the provisions in subpart FC should be reviewed, with appropriate amendments included if necessary to ensure there is no inconsistency, confusion or anomalous outcomes.

Comment

We have reviewed the provisions in subpart FC and have identified it should be clarified that section FC 9 overrides sections FC 3 and FC 4.

Recommendation

That the submission be accepted, subject to officials' comments.

RELATIONSHIP PROPERTY

Clauses 10, 10B and 10C

Issue: Alignment with inheritance

Submission
(KPMG)

There is no rationale for distinguishing between the tax treatments of subsequent sales of inherited and relationship property. The latter will be subject to the bright-line test, whereas the former will not.

The justification given by officials was that there is more opportunity to negotiate the property that a transferee receives under a relationship property agreement. This assumes that the transfer will be amicable, which will not always be the case.

Further, if one of the reasons for applying the bright-line test to subsequent disposals of relationship property is that it can be presumed that both parties had a joint purpose or intention when acquired, then the start date should be the original purchase date.

Comment

It is proposed that inherited property be excluded from the bright-line test because in the case of inheritance the person did not intend to acquire the property.

The bright-line bill proposes that the exception for property transferred under a relationship property agreement is narrower. This is because:

- In most cases property subject to the bright-line would have been acquired during the relationship. This means we can presume that the two parties had a joint intention in acquiring the property.
- Unlike inheritance, the parties have scope to negotiate the transfer of the property.

Recommendation

That the submission be declined.

Issue: Use of term "date of acquisition"

Submission
(EY)

Section FB 3A should be revised to remove the reference to "date of acquisition". This should be reworded.

Comment

We agree with the submission.

Recommendation

That the submission be accepted.

OTHER EXCEPTIONS

Issue: Exceptions for circumstances outside seller's control

Submission

(New Zealand Property Investors' Federation Inc, Chartered Accountants Australia and New Zealand, EY, PwC, KPMG, nsaTax, Chapman Tripp, New Zealand Law Society)

Submitters sought exceptions from the bright-line test for various circumstances where the seller is forced to sell property due to circumstances outside of their control. Submitters stated that as the bright-line test is intended to be a supplement to the existing intention test it should not apply when the seller is forced to sell the property due to circumstances outside of their control.

Exceptions were sought for:

- sales due to financial hardship;
- compulsory acquisitions;
- mortgagee sales; and
- corporate and personal insolvencies.

Comment

The primary objective of the bright-line test is to be an easy to enforce rule. For the bright-line test to be effective the number of exceptions should be limited and defined tightly. Exceptions such as hardship would make the bright-line test more subjective and difficult to enforce. Providing additional exceptions to the bright-line test would increase the complexity of the bill while reducing its effectiveness and making it less clear and objective.

Existing hardship provisions in tax law are available to provide relief for taxpayers who cannot afford to pay. In addition, the main home exception will mean that a person's main home will not be taxed by the bright-line test.

Part of the generic tax policy process involves a post-implementation review. We will monitor this area to ensure the bright-line test is working as intended.

Recommendation

That the submission be declined.

Issue: Exception for persons who hold leasehold title in property prior to obtaining freehold title

Submission

(New Plymouth District Council)

There should be an exception from the bright-line test for persons who hold a leasehold title in respect of the property prior to the purchase of a freehold title, the leasehold title has a perpetual right of renewal, and the person has held the leasehold title or the freehold title for at least two years.

The bright-line test is intended to capture speculators. Where persons hold a lease with a perpetual right of renewal, it will be common for them to obtain freehold title prior to selling the land, to make it easier to sell. These people are not speculators and it would be administratively difficult for them to administer the bright-line test. Treating leases with a perpetual right of renewal similarly to freehold estates is also consistent with recent changes made in the Taxation (Annual Rates, Employment Allowances, and Remedial Matters) Act 2014.

Comment

For the bright-line test to be effective, the number of exceptions should be limited and defined tightly.

However, we can see a good case for a narrow exception in this situation. Leases with a perpetual right of renewal are very similar to freehold title and other tax provisions treat them similarly.

Recommendation

That the submission be accepted.

Issue: Rollover relief for associated persons

Submission

(nsaTax, Chapman Tripp)

The bill provides for no loss from a transfer of property to an associated person. However the bill does not provide for the inverse situation to provide rollover relief for gains.

A person may choose to place their property into a trust or restructure for genuine commercial reasons within two years of acquiring the property.

This should not be subject to the bright-line test. Instead, rollover relief should be provided and the associated person should obtain the property at cost with the benefit

of the acquisition date of the transferor. This would better reflect the economic reality where the associated persons are effectively one economic unit.

This would also remove the incentive for a taxpayer to realise an unrealised loss. Only genuine third-party sales would trigger losses under the bright-line.

Comment

For the bright-line test to be effective, the number of exceptions should be limited and defined tightly.

We consider that having rollover relief for associated persons would increase the complexity of the bright-line test and result in it being less clear. Not having general rollover relief is consistent with the current land sale rules, which do not provide rollover relief for gains realised on a transfer to an associated person.

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.

Recommendation

That the submission be declined.

HOLDING COSTS FOR PROPERTY SUBJECT TO THE BRIGHT-LINE SHOULD BE DEDUCTIBLE

No clause

Submission

(Chartered Accountants Australia and New Zealand, nsaTax, New Zealand Law Society, PwC, KPMG)

Holding costs for property subject to the bright-line test should be deductible.

This would be the result if the standard deductibility rules applied to the property, otherwise the legislation should explicitly provide an automatic right of deduction for the property.

An explicit provision would be consistent with how deductions are treated for other revenue account property, more equitable, and allowing deductions ensures that only the gain on the sale is taxed.

Current rules provide a deduction for holding costs as holding costs do not exclusively relate to "living as an individual" and therefore are not subject to the private limitation. This is because these costs are incurred irrespective of whether the property was used or available for use for private purposes.

Inland Revenue should provide guidance on this point in a *Tax Information Bulletin*.

Comment

The bill proceeds on the basis that holding costs for property subject to the bright-line are deductible according to ordinary tax rules. No separate rules for the bright-line are proposed.

This is to ensure that the rules for deductions for the bright-line are aligned with the rules for deductions generally. This ensures that the framework for deductions is maintained and ensures there are no distortions caused by having people wanting to accelerate or delay sales into or outside of the bright-line period as a result of the differing treatment for deductions.

In accordance with the framework for deductions, deductions are not allowed for expenditure to the extent to which it is of a private or domestic nature. This is to ensure that income is calculated before deducting any consumption expenditure.

We do not consider that current deductibility rules would allow for holding costs to be deductible for revenue account property when the property is used only for private purposes.

The deductibility of holding costs is a current issue, which is not created or limited to the bright-line test. We 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. Officials intend to consider this area further.

Recommendation

That the submission be declined.

RING-FENCING LOSSES

Clause 8

Issue: Opposition to ring-fencing losses

Submission
(New Zealand Property Investors' Federation Inc, Chartered Accountants Australia and New Zealand, nsaTax, New Zealand Law Society, EY, PwC, Chapman Tripp, KPMG)

Submitters did not support the proposal to ring-fence losses from sales taxable solely due to the bright-line test.

Reasons given for this were:

- Gains and losses that arise under the bright-line test should be treated in the same manner as other gains and losses that arise under the other sections of subpart CB.
- Taxpayers will have an incentive to argue that they had an intention of resale for any losses, which will increase compliance costs and render ring-fencing ineffective.
- Ring-fencing losses will distort investment decisions and will encourage economically inefficient behaviour. The bright-line test will capture many situations where the taxpayer is forced to sell due to financial strife; losses in these cases should be dealt with on the same footing as gains.
- Ring-fencing would mean that many people will have unusable losses.
- Taxpayers are unlikely to accelerate property sales to realise losses as the benefit from the tax losses would give rise at most to a 33 percent recovery, while the true economic loss is much greater.
- Ring-fencing creates a "one-way bet" for government.

Comment

The two-year nature of the bright-line test would cause a significant revenue risk if unrestricted losses were allowed. The bright-line test creates an incentive for people with unrealised losses to accelerate sales and an incentive for those with unrealised gains to defer sales. This means that people are able to maximise claimable losses and minimise taxable gains. This revenue risk would be particularly large in a downturn, when people are likely to sell recently acquired property at a loss.

Ring-fencing is intended to reduce the revenue risks by removing the ability to offset losses against all other income (such as salary and wages), and therefore reduce the incentive to accelerate losses.

The proposed ring-fencing is as limited as possible while still addressing the revenue risks. This includes limiting ring-fencing to sales that are taxable solely due to the bright-line test, and allowing ring-fenced losses to be offset against any future land sale gains. 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, thereby mitigating any distortions.

Recommendation

That the submission be declined.

Issue: Group companies

Submission
(EY)

Companies should 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. There is no general income tax restriction on the type or source of losses that companies can offset against net income derived by other tax group companies and we cannot see any justification for restricting the offset.

Comment

Enabling group companies to offset ring-fenced deductions against land income from other group companies would increase the complexity of the proposed ring-fencing and make the bright-line test less clear.

We note that consolidated groups will be able to offset ring-fenced deductions against the land income from other consolidated companies.

Recommendation

That the submission be declined.

Issue: Spill-over

Submission
(PwC, EY)

Given the hierarchical application of the land taxing provisions there is potential for losses to be ring-fenced where the property sale would otherwise have been taxable under a subsequent provision without loss limitation. This spill-over produces an unintended loss limitation.

Comment

The proposed ring-fencing only applies where the sale is taxable solely due to the bright-line test.

Recommendation

That the submission be noted.

LOSSES FROM TRANSFERS TO ASSOCIATED PERSONS

Clause 8

Issue: Support for denying losses from transfers to associated persons

Submission
(New Zealand Property Investors' Federation Inc)

The submitter supported the proposed denial of losses from transfers to associated persons.

Recommendation

That the submission be noted.

Issue: Opposition to denying losses from transfers to associated persons

Submission
(nsaTax)

Losses from transfers to associated person transactions should be allowed in full.

At the very least they should be ring-fenced in the same way as proposed for losses arising from third-party transactions.

The solution to this is to provide rollover relief for transfers to associated persons. (See *Issue: Rollover relief for associated persons*).

Comment

The bill proposes to deny losses from transfers to associated persons to prevent people recognising losses without any real economic transaction occurring.

For the reasons outlined for the submission *Issue: Rollover relief for associated persons* we do not agree with providing rollover relief for transfers between associated persons.

We are proposing to adjust the cost base for the recipient of property to prevent genuine losses being denied permanently through transfers to associated persons (see *Issue: Adjusting cost-base of associate*).

Recommendation

That the submission be declined.

Issue: Limiting provision to disposals taxable solely due to the bright-line

Submission
(nsaTax, EY)

The proposed denial of losses from transfers to associated persons should only apply to a person who derives income solely under section CB 6A.

Section DB 18AB applies to a person who derives income under section CB 6A. This section should be amended so that the deduction cap on associated person transactions is limited to income derived solely under section CB 6A.

Without amendment the deduction cap could apply to land which is taxable under other provisions.

Comment

The limit to losses from transfers to associated persons is only intended to apply to transactions taxable solely due to the bright-line test. We agree that section DB 18 AB should be amended to reflect this.

Recommendation

That the submission be accepted.

Issue: Cross-reference error

Submission
(nsaTax)

Section DB 18A(2) refers to subsection (3). The reference should be to subsection (4).

Comment

Officials agree with the submission.

Recommendation

That the submission be accepted.

Issue: Adjusting cost base of associate

Submission
(EY, Chapman Tripp)

Any undeducted cost balance for the transferor should become part of the cost base for the associated transferee.

When transferees acquire land from associated persons they should also be treated as acquiring the land at the same date as the transferor.

This may however create the ability for associated persons to transfer losses.

Comment

We agree with submitters that if the cost base of the asset is not adjusted it could result in genuine losses being denied permanently due to an intermediate transfer to an associated person. As a result we recommend providing an adjusted cost base to the transferee.

However we do not recommend adjusting the date of acquisition for the transferee. We consider that the rule will be simpler if the date of acquisition remains unchanged for associated party transfers. We also note that in the case of a property that has made a genuine loss, having a longer bright-line period would be more taxpayer-friendly.

Recommendation

That the submission be accepted, subject to officials' comments.

LAND-RICH COMPANIES AND TRUSTS

Clause 14

Issue: Support for proposed anti-avoidance rule

Submission
(New Zealand Property Investors' Federation Inc)

The submitter supports rules to prevent the use of companies and trusts to circumvent the bright-line test.

Recommendation

That the submission be noted.

Issue: Opposition to proposed anti-avoidance rule

Submission
(New Zealand Law Society, Chartered Accountants Australia and New Zealand, PwC, Chapman Tripp, KPMG)

Submitters did not support the proposed anti-avoidance rule. Reasons given for this opposition included:

- The general anti-avoidance rule gives Inland Revenue sufficient power to challenge those who act to avoid the bright-line test. In addition, disposals of shares that are part of a profit-making undertaking or scheme are taxable under section CB 3.
- Common occurrences such as death, divorce or change of advisor would inadvertently trigger the proposed anti-avoidance rule. The wide definitions used in the rules create a risk of inadvertent capture of common situations.
- It is unlikely that taxpayers will use companies to acquire residential land as this exposes the taxpayer to other liabilities and is not a commercially viable way of acquiring residential land as well as other securities law obligations that arise. The small number of transactions does not justify the introduction of a specific rule.
- There is no principle to distinguish between good and bad share sales under the proposed test.
- If you want to tax the sale of land-rich shares this should be set out in clear terms that apply to all taxpayers. The proposed anti-avoidance rule will only apply when Inland Revenue chooses to invoke the rule.

- The international tax issues with taxing land-rich companies have not been properly considered.
- A "wait and see" approach should instead be adopted.

Comment

It is important that people cannot easily avoid the bright-line test through the use of companies and trusts. The use of a specific anti-avoidance rule is intended to supplement the general anti-avoidance rule by showing that Parliament clearly intends that avoidance rules are to apply to the use of land-rich companies and trusts to avoid the bright-line test.

Recommendation

That the submission be declined.

Issue: Exempting rental property

Submission
(New Zealand Property Investors' Federation Inc)

Consideration should be given to exempting property that is to be used to provide tenants with long-term rental accommodation from the proposed anti-avoidance rules. *(New Zealand Property Investors' Federation Inc)*

Comment

The bright-line test applies to residential property that is bought and sold within two years whether or not it is used for rental purposes. As a result, the anti-avoidance rule should also apply irrespective of whether the property is intended to be used for rental purposes.

Recommendation

That the submission be declined.

Issue: Making rules as simple as possible

Submission
(New Zealand Property Investors' Federation Inc)

The rules should be the simplest required to eliminate the use of companies and trusts to circumvent the bright-line test.

Comment

Officials consider that the proposed anti-avoidance rule is the simplest means of addressing the issue of land-rich companies and trusts while providing an effective counter to the avoidance risks.

Recommendation

That the submission be noted.

Issue: Ownership of multiple properties

Submission
(Chartered Accountants Australia and New Zealand)

Clarification is needed when a company owns a number of properties and some were purchased during the bright-line period. It is unclear whether the bright-line test will apply when shares of the company are sold.

Comment

When section GB 52 applies, it is intended that the bright-line test only applies to the properties that have been acquired within two years of the share disposal.

We agree that section GB 52 should be amended to reflect this.

Recommendation

That the submission be accepted.

Issue: International tax implications

Submission
(Chartered Accountants Australia and New Zealand)

It is arguable that some of New Zealand's double tax agreements do not allow New Zealand to impose tax on the gains made on the sale of shares. For example, shares in a New Zealand company owning residential property held by a German resident. Assuming the sale of the shares gives rise to New Zealand-sourced income under the new bright-line provisions, the German resident would apply Article 13(4) of the Germany-New Zealand Double Tax Agreement to be taxed only in Germany in respect of the income.

It appears that the introduction of proposed section GB 52 is intended to override the application of such articles. The application of the bright-line test to non-resident

shareholders of land-rich companies under New Zealand's double tax agreement network needs to be considered and its implications spelled out.

Comment

Proposed sections GB 52 and GB 53 are specific anti-avoidance rules. In certain circumstances, a shareholder of a land-rich company, or trustee of a land rich trust, will be treated as disposing of land for the market value.

Inland Revenue's view is that the proposed legislation does not raise any issues of override in this situation. This is because specific anti-avoidance rules are applied to the situation to establish the appropriate tax result under New Zealand's domestic law, and then the relevant double tax agreement will be applied to that tax result.

However, it should be noted that the benefits of a double tax agreement are not available when a main purpose for entering into certain transactions or arrangements is to secure a more favourable tax position, obtaining more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provision. This is likely to be the case when sections GB 52 or GB 53 apply.

Recommendation

That the submission be noted.

Issue: Should allow deductions for shareholder

Submission
(nsaTax, EY)

The proposed anti-avoidance rule does not allow the shareholder or trustees to claim any deductions for the cost price of the land, capital expenditure, or related selling costs (including cost of shares). This is because it is the company that incurred the costs, but it is the shareholder who is treated as receiving the gain. This could lead to over-taxation.

Comment

We agree that the shareholder or trustee should be able to claim a deduction for the cost of residential land as well the other deductions available to a seller of land.

In the case of a trustee, we consider the current drafting would achieve this as section GB 53 deems the trustee to have disposed of the land. The trustee will have incurred the cost of the residential land and so will be entitled to a deduction.

In the case of a shareholder we consider that section GB 52 should be amended to entitle them to a deduction that would have been available if they had sold the land themselves.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Determining value of company or trust assets

Submission
(nsaTax, PwC, EY)

The land-rich company rule refers to the company's residential land making up "…50% or more, by value, of the assets of the company;". The provision needs to clarify what "value" it is referring to as there are multiple possibilities and the time at which such measurement should be made.

It also needs to be clarified at what point in time the value is measured.

Section GB 53 suffers the same gross inadequacies. *(nsaTax)*

The anti-avoidance rule uses the term "value". This is undefined and the later reference in the section to "market value" could imply the term had a different meaning. *(EY)*

Comment

We consider that the method for determining "value" should be clarified by making clear that it should be "market value" that is considered.

With reference to the point at which point you determine the respective values, we consider that the current bill is clear in that the time you determine the values is the time that the actions in sections GB 52(1)(c) or GB 53(1)(c) occur.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Adjusting cost base of company

Submission
(nsaTax)

If the anti-avoidance rule applies, the company should be deemed to have acquired the land at market value to avoid the same gain being taxed if the company sells the land within two years of acquisition.

If section GB 52 applies, the company should be deemed to have acquired the land at market value to avoid the gain being double-taxed if the company later sells the land.

Comment

We agree that the current provision could lead to over-taxation. Adjusting the cost base for the company is a sensible means of addressing this.

Recommendation

That the submission be accepted.

Issue: Disposal of all residential land when there is a partial sale of shares

Submission
(New Zealand Law Society)

The proposed anti-avoidance rule could lead to over-taxation. A sole shareholder will be treated as having disposed of all of the residential land owned by the company when that shareholder disposes of 50 percent or more of their shares to a third party. Given that they retain up to 50 percent of the shares, taxing the full gain from the land would over-tax them.

Comment

We agree that the rule should be amended to ensure that the person is only taxed on the gain from the land proportional to the amount of shares that they actually disposed of.

Recommendation

That the submission be accepted.

Issue: Arrangement under the trust

Submission
(New Zealand Law Society)

The phrase “an arrangement under the trust” is unclear. Officials could treat almost any arrangement as “an arrangement under the trust” for the purpose of invoking the specific anti-avoidance rule. The section should not refer to changes in “an arrangement under the trust”.

Comment

The provision for “an arrangement under the trust” is intended to cover several situations when trusts could be used to avoid the bright-line test. This would include a change in the beneficiaries of a trust or the termination of the trust.

For the proposed anti-avoidance rule to apply there would still need to be a purpose or effect of defeating the intent and application of the bright-line test. This limits the application of the rule in the case of an arrangement.

Recommendation

That the submission be noted.

Issue: Allowance for land acquired before 1 October 2015

Submission
(PwC)

There is currently no allowance for land acquired before 1 October 2015 in the proposed anti-avoidance rule. This land should be excluded from the rule.

Comment

The proposed anti-avoidance rule only applies when there are actions that have the purpose or effect of defeating the intent and application of the bright-line test.

As the bright-line test only applies to land acquired on or after 1 October 2015, there will only be a purpose or effect of defeating the intent and application of the bright-line test in relation to actions that relate to land acquired on or after 1 October 2015.

Recommendation

That the submission be declined.

Issue: Clarifying which trustee derives income

Submission

(nsaTax)

Proposed section GB 53 should be modified to clarify which trustees are liable for any tax liability resulting from the application of the section.

Comment

Where there are two or more trustees of a trust, section HC 2 treats them as if they were a notional single person and they are jointly and severally liable to satisfy the income tax liability of the trust.

Recommendation

That the submission be declined.

APPLICATION DATE

Clauses 4 to 13

Issue: Clarification on rules for application date

Submission
(EY)

The application clauses refer to the date a person "first acquires an estate or interest". This appears to be intended to be the same as that in section CB 15B.

Section CB 15B expressly does not apply to section CB 6A. This should instead refer to section CB 6A(1) to remove uncertainty.

The commentary to the bill states that the application date for the bright-line rule is for sales where registration is after 1 October 2015, when the land is acquired other than by sale. There is no statutory provision to this effect and it does not necessarily accord with section CB 15B.

Comment

Section CB 15B is a substantive provision that has no impact on the application date. We therefore do not consider that amending section CB 15B would have any effect on the proposed application date.

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).

As the submitter has noted, this may not always be the case. 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.

We will clarify this in the *Tax Information Bulletin*.

Recommendation

That the submission be declined.

Issue: Application date for loss ring-fencing

Submission

(New Zealand Law Society)

The application date for the loss ring-fencing rules is residential land acquired "after 1 October 2015". This should be "on or after 1 October 2015".

Comment

Officials agree with the submission.

Recommendation

That the submission be accepted.

Issue: Application date for anti-avoidance provisions

Submission

(Matter raised by officials)

The current application date of the anti-avoidance provisions refers to when a person disposes of residential land. However, the anti-avoidance rules apply only in circumstances when there has not been a disposal of residential land.

Comment

The application date for the anti-avoidance rule should be changed to 1 October 2015.

Recommendation

That the submission be accepted.

Other policy matters

TRUST FILING EXCEPTION

Clause 16

Issue: Support for proposal

Submission
(Chartered Accountants Australia and New Zealand, PwC)

Submitters supported the proposed amendment.

Recommendation

That the submission be noted.

Issue: Minimal income and expenditure

Submission
(Chartered Accountants Australia and New Zealand, PwC, KPMG)

The minimal amount of income exemption should be set at $1,000 if income is taxed at source at the default rate, rather than $50 as this would make a much more meaningful difference to compliance cost savings. *(Chartered Accountants Australia and New Zealand)*

The de minimus for administration costs should be increased. *(PwC)*

The exclusion for non-active trusts needs to have a more reasonable income threshold. At present it is limited to bank interest and cannot exceed the $50 of administration costs allowed. There is no practical value from trusts having to file tax returns for minimal amounts. *(KPMG)*

Comment

We agree that the proposed exception should be extended to achieve more compliance cost savings.

We consider that trusts should be treated as having nil income for the purpose of the exception if their relevant income or expenditure is less than $200, rather than $50 as proposed in the bill.

We also propose that, in determining whether the trust has no deductions that interest, rates and other expenditure incidental to the occupation of the property and incurred by a beneficiary of the trust, are disregarded.

These changes should help ensure that the amendment reduces compliance costs for taxpayers.

Recommendation

That the submission be accepted, subject to officials' comments.

Issue: Non-active entity

Submission
(New Zealand Law Society)

The requirement that the trust not have disposed of any assets is not required for the rule as distributions of capital by a complying trust are not subject to income tax.

The requirement that the trust not have disposed of any assets should therefore be removed as it would increase compliance costs but not increase the tax take.

Comment

We agree with the submission.

Recommendation

That the submission be accepted.

Issue: Limiting expenditure requirement to expenditure that is deductible

Submission
(PwC)

Family trusts will often hold private assets and incur expenditure that is not deductible for income tax purposes. However proposed section 43(3)(b) refers to costs rather than deductions. The provision should be clarified to confirm that it is only expenditure that would be deductible for income tax to the trust that is to be considered.

Comment

The structure of the new provision is that subsection (2) refers to tax concepts of income and deductions. Subsection (3) refers to actual incomings and outgoings such as fees and bank charges. These concepts should not be mixed.

As a result we do not support the proposed amendment, which would incorporate tax concepts into subsection (3), which would be inconsistent with the structure of the new section.

Recommendation

That the submission be declined.

Issue: Inland Revenue should provide guidance

Submission
(New Zealand Law Society)

Many trusts, including trusts that own only non-income producing assets such as the family home, do not obtain an IRD number or file income tax returns.

Inland Revenue should confirm that trusts that do not (and are not required to) obtain an IRD number are not required to file income tax returns if those trusts do not derive income or are not otherwise taking a tax position.

Comment

The proposed amendment will provide that complying trusts that do not have any income or deductions (as defined in the provision) do not have to file returns. The provision will be explained in the *Tax Information Bulletin* for the bill.

Recommendation

That the submission be noted.

Issue: Net filing income threshold for individuals

Submission
(KPMG)

The $200 non-filing income threshold for individuals has been unchanged for over 15 years. It is therefore timely for this to be increased to take into account inflation. A $500 net income threshold, for both individuals and non-individuals is more reasonable.

Comment

This submission refers to matters that are not part of the bill.

Recommendation

That the submission be declined.

Issue: Defining "professional trustee"

Submission
(Matter raised by officials)

We consider it preferable to define what is a "professional trustee" for the purposes of this amendment.

We consider that using the definition contained in section 13C of the Trustee Act would be appropriate. Section 13C of the Trustee Act 1956 defines a professional trustee as a person "where a trustee's profession, employment, or business is or includes acting as a trustee or investing money on behalf of others".

Comment

We consider the proposed definition would help provide greater clarity in the legislation.

Recommendation

That the submission be accepted.

Remedial amendments

AMALGAMATIONS – REFERENCE TO AMALGAMATING AND AMALGAMATED COMPANIES

Clause 13

Submission
(EY, nsaTax)

The proposed section contains references to "amalgamating company" which should be "amalgamated company".

Comment

Officials agree with the submission.

Recommendation

That the submission be accepted.

Matters raised by the Committee

EXAMPLE SCENARIOS

The Committee has asked for example scenarios to demonstrate how the bright-line test would work in practice.

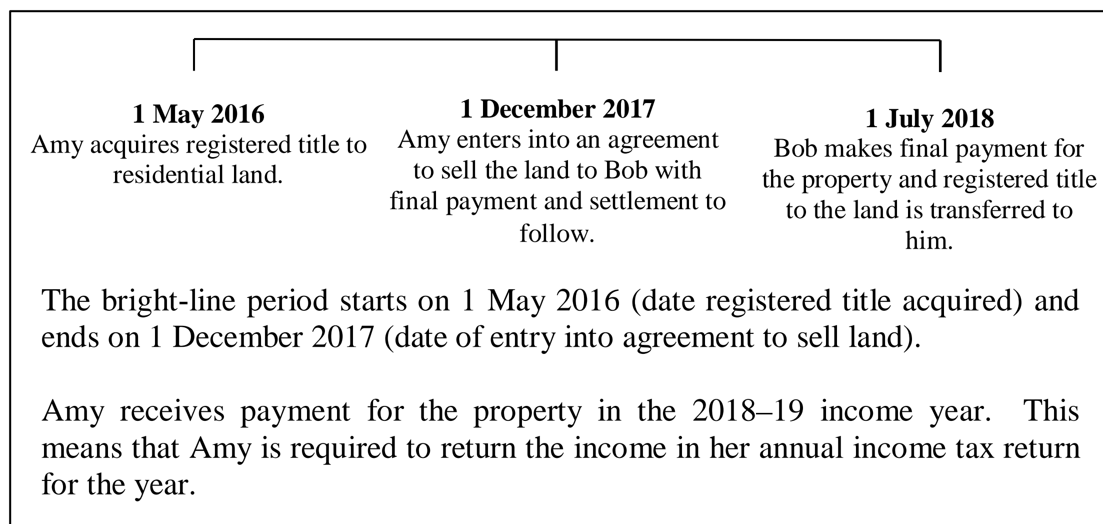
Several of these example scenarios may change if recommended amendments to the bill contained in this Officials' Report are accepted. Where these amendments would affect the outcome in the example scenario the impact of the change is outlined underneath the example.

Examples

Two-year time period

Standard scenario

For standard sales of land the two-year bright-line period starts at the time a person acquires registered title to land and ends when a person enters into an agreement to dispose of the land.



The bright-line period starts on 1 May 2016 (date registered title acquired) and ends on 1 December 2017 (date of entry into agreement to sell land).

Amy receives payment for the property in the 2018–19 income year. This means that Amy is required to return the income in her annual income tax return for the year.

Sales where there is no registration of title

For a sale "off the plan" (when the land is bought and sold prior to obtaining registration of title), the bright-line period starts at the time a person enters into an agreement to acquire the land and ends when a person enters into a contract to dispose of the land.

> A developer is building an apartment block. The developer plans to finish construction in 2019 and is selling rights to the titles of the eventual apartments "off the plan".
>
> **1 May 2016**
> Developer enters into a contract to sell apartment A to Cory.
>
> **1 July 2016**
> Cory enters into an agreement to sell apartment A to Denise.
>
> **1 May 2019**
> Construction is finished and the developer creates a unit title for apartment A. Apartment A is transferred to Denise.
>
> The sale of the right to buy A by Cory to Denise is covered by the bright-line test. This is because he entered into an agreement to sell apartment A (1 July 2016) within two years of entering a contract to purchase apartment A (1 May 2016).

Sale off the plan and there is registration of title.

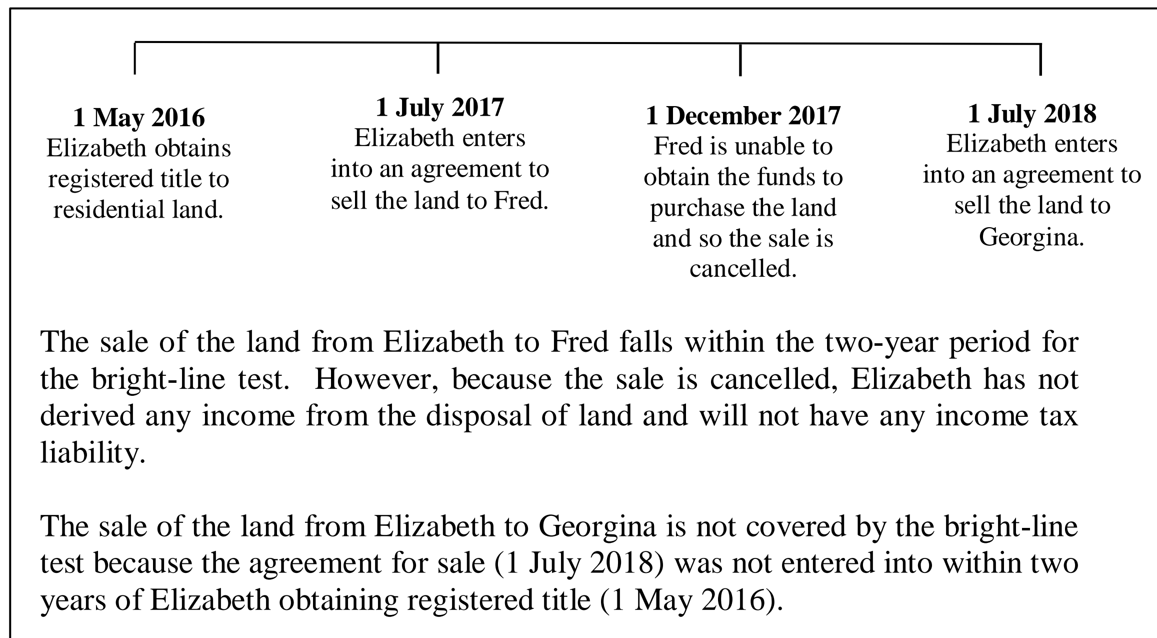
> A developer is building an apartment block. The developer plans to finish construction in 2019 and is selling rights to the titles of the eventual apartments "off the plan".
>
> **1 May 2016**
> Developer enters into a contract to sell apartment A to Peter.
>
> **1 May 2017**
> Construction is finished and Peter obtains registered title to land.
>
> **1 July 2018**
> Peter enters into an agreement to sell the land to Paul.
>
> The sale of the land from Peter to Paul is covered by the bright-line test. This is because the start date for the bright-line is 1 May 2017 (the date Peter obtained registered title) and the end date is 1 July 2018 (the date Peter enters into an agreement for sale of the land).

Proposed amendment for sales off the plan

If the proposed amendment to sales off the plan is agreed to (*Issue: Sales "off the plan*"), then the sale of the land from Peter and Paul will not be covered by the bright-line test. This is because the start date of the bright-line test will instead be 1 May 2016 (the date Peter entered into a contract to purchase the title "off the plan").

Sale that is cancelled

For sales that are cancelled, there will be no income tax to be paid under the bright-line test because there has been no income derived from the sale.



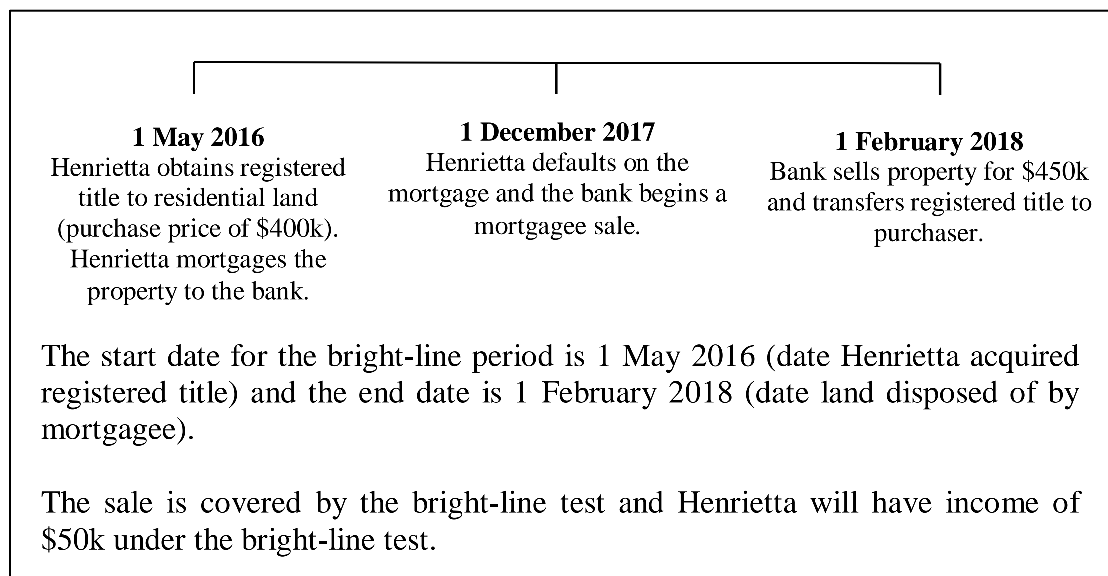
The sale of the land from Elizabeth to Fred falls within the two-year period for the bright-line test. However, because the sale is cancelled, Elizabeth has not derived any income from the disposal of land and will not have any income tax liability.

The sale of the land from Elizabeth to Georgina is not covered by the bright-line test because the agreement for sale (1 July 2018) was not entered into within two years of Elizabeth obtaining registered title (1 May 2016).

Disposal of land that does not involve a contract to sell

There are several situations when land is disposed of and there is no agreement to dispose of the property by the owner (for example, a mortgagee sale). In these situations, the proposed end date for the bright-line period differs from the standard rule.

For mortgagee sales, the proposed end date for the bright-line period is the date that the land is disposed of by the mortgagee.

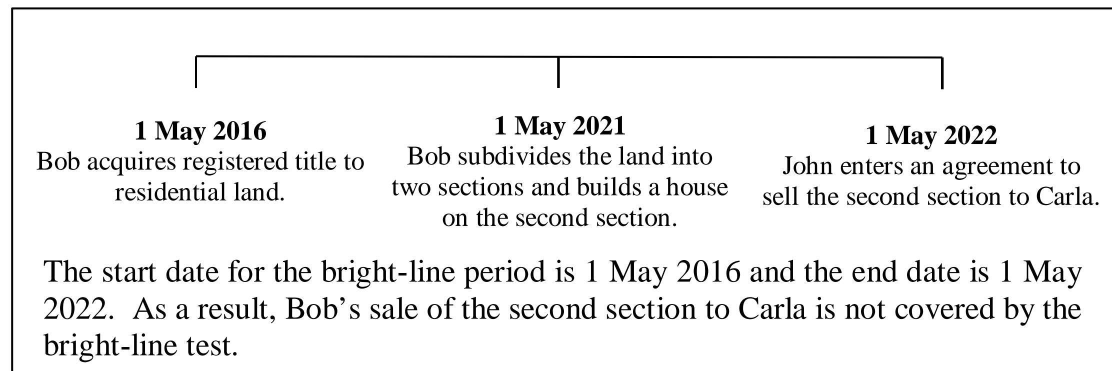


The start date for the bright-line period is 1 May 2016 (date Henrietta acquired registered title) and the end date is 1 February 2018 (date land disposed of by mortgagee).

The sale is covered by the bright-line test and Henrietta will have income of $50k under the bright-line test.

Subdivision

The start date for the bright-line period when land is subdivided is the date the owner originally acquired the undivided land.



The start date for the bright-line period is 1 May 2016 and the end date is 1 May 2022. As a result, Bob's sale of the second section to Carla is not covered by the bright-line test.

Residential land

The proposed bright-line test will apply only to residential land.

Land is "residential land" if either:

- the land has a dwelling on it; or
- there is an arrangement to put a dwelling on it; or
- it is bare land that because of its area and nature is capable of having a dwelling on it.

However, even if land meets one of these three requirements it is not "residential land" if it is used predominantly as business premises or is farmland.

Development

Andrew buys an empty plot of land. He plans to develop the plot by subdividing it into four lots and building houses on each of the lots.

Andrew sells lot 1 off the plan to Bob. One month later, Bob sells lot 1 to Carla.

Lot 1 would be "residential land" and Bob would be subject to the bright-line test as there is an arrangement to build a dwelling on it, and because it is bare land, that due to its area and nature is capable of having a dwelling on it.

Farmland

Farmland is land that because of its area and nature is capable of being worked as an economic unit as a farming or agricultural business.

Land that because of its nature is not capable of being used as farmland

Tina owns a 50 hectare plot of land. The land is covered in gorse.

The land is not farmland as it is not currently capable of being used for farming purposes.

Land that because of its area is not capable of being used as farmland

Marama purchases a lifestyle block with a house and a small area of farmland. A small number of sheep are kept on the land to keep the grass down.

The farming exclusion will not apply as the land is not capable of being worked as an economic unit as a farming business. It is a hobby farm rather than a genuine farming business.

If the area of farmland was larger and capable of being used as an economic unit for farming purposes, it would likely be covered by the farming exclusion.

Small plot of land that is farmland

Uri has a 5 hectare plot of land that is suitable for use as a rose farm.

This land is farmland as it is currently capable of being used as an economic unit for farming purposes.

Business premises

Bed and breakfast

Mary owns a bed and breakfast. Mary provides meals to the residents, room service and cleans the rooms she lets out every day.

The land has a dwelling on it so meets the first criteria for residential land. However, the land would not be "residential land" as the land is used predominantly as the business premises for the bed and breakfast.

Worker's quarters

Steve owns land which contains a factory which is used to process food. The land also has workers' quarters on it, which Steve provides to his employees to use as residences.

The land is used predominantly as business premises and so is entitled to the business premises exception.

Empty factory

Velma purchases an empty factory which she plans to develop into an apartment building.

Before beginning construction Velma receives a good offer for the building and sells it to William.

Velma has an arrangement to put a dwelling on the land and so meets the first criteria for residential land. The land does not qualify for the business premises exclusion as it is empty and not being used as business premises at the time of disposal. As a result the land is "residential land" and potentially subject to the bright-line test.

Recommended amendments to definition of residential land

We are recommending changes to the definition of "residential land" (see *Issue: Farmland*, and *Issue: Bare land*). In the example scenarios provided above we do not believe the recommended changes would affect the end result.

Main home

The bright-line test will not apply to the disposal of a person's main home.

To utilise the main home exception a person must have used most of the land as their main home for the majority of time they have owned the land.

Multiple dwellings

Bill buys an apartment block on a single title. He lives in one of the apartments as his main home and rents out the remaining six apartments. Bill sells the apartment block to a third party. Bill cannot use the main home exception because the land (contained on the single title) was not used predominantly as his main home. The majority of the land was used as rental property.

Lifestyle block

Bob purchases a 2 hectare block of former farmland and builds a house on it. Bob lives in the house as his main home with his family. The remaining land is used by the family to keep some family horses to ride and to run a handful of sheep to keep the grass down. Bob will be able to use the main home exception because the entire land has been used by Bob as his main home.

Country store and house

Barbara buys a country store that has living quarters attached. She resides in the living quarters and runs a retail business from the front half of the property. She estimates that the retail business uses 45 percent of the property and claims expenses (insurance and rates) on that basis against the retail income. Barbara sells the property.

Barbara is not able to use the business premises exception as the land is not used predominantly for her retail business (45 percent).

However, Barbara can utilise the main home exception because she has used the property predominantly (55 percent) as her main home during the time she has owned the property. She uses her previous estimate for her expenses to prove her actual use of the property.

Purchase of lifestyle block - A

Bob and Deb decide to move from the city to the country. They buy a 15 acre (6 hectare) block on which there are the following buildings:

- a two-storey building that consists of a large room and office downstairs and basic two-bedroom accommodation upstairs;
- a large shed; and
- six un-used glasshouses.

They move in and purchase some livestock to keep the grass down and the freezer full. The couple start looking at their options for improving their accommodation.

The land is not eligible for the farmland exclusion because it is not large enough to be an economic unit for farming purposes.

However they would be able to use the main home exception as all of the areas are used for their residence.

Purchase of lifestyle block - B

The couple then look at their options for improving their accommodation. They consider the following:

- renovating the house and bringing the downstairs area into use as part of the home; and
- building a new home and renting out the old one.

They also consider how the glasshouses could be used to supplement their income. They consider establishing a cut flower-growing business in the glasshouses, using the large shed as a packing room and chiller area.

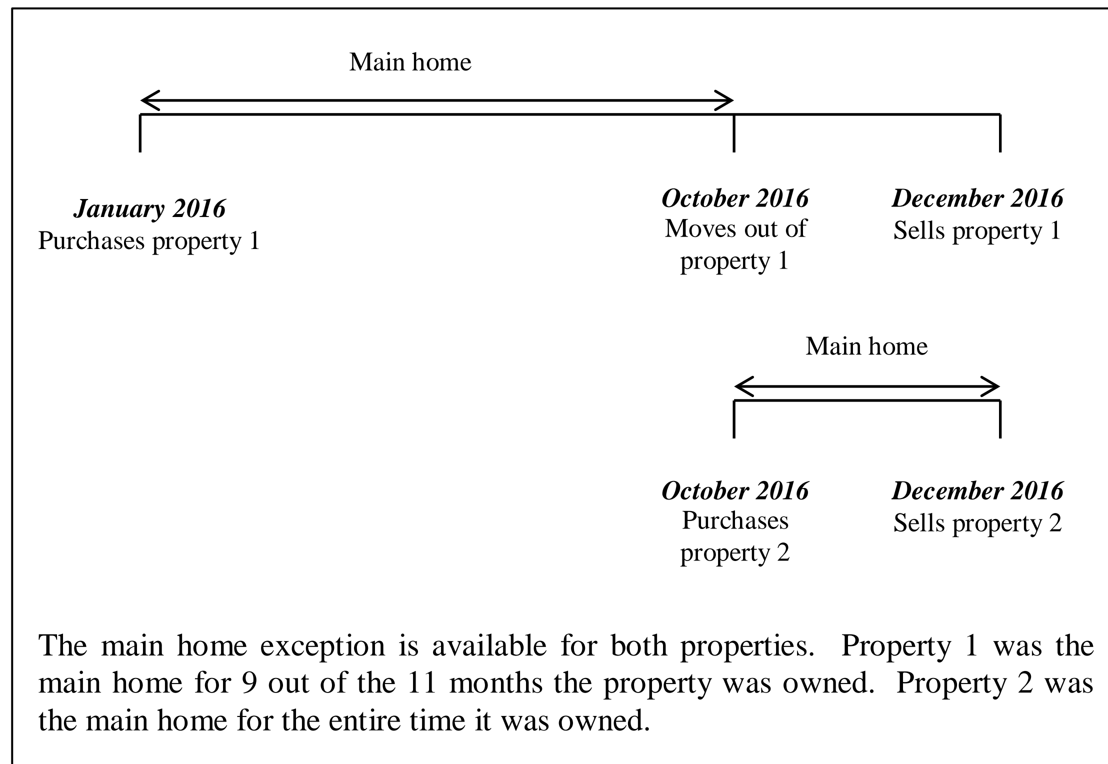
They also consider leasing out half of the paddocks for horse grazing.

If the property was later sold, the changes being contemplated would have the following effects:

- Renovation of the house to include the ground floor as part of their home would not change the application of the main home exemption.
- If a new house was built and the old one rented out, there would be multiple dwellings on the property. However, as the new home and paddock area would exceed the area of the rental property, the main home exemption would still apply.
- Utilising the glasshouses would also have no effect as the area of the rental house and the glasshouses would not exceed the area of the house and paddocks.
- Leasing out half of the paddocks for grazing would be the one change that would be likely to result in the main home exemption being no longer available. This is because the area used for their own purposes would probably not exceed the area of the glasshouses, the rental home and the leased paddocks.

Main home exception for multiple properties

In limited circumstances a person may use the main home exception for two properties at the same time.



The main home exception is available for both properties. Property 1 was the main home for 9 out of the 11 months the property was owned. Property 2 was the main home for the entire time it was owned.

Main home and trusts

Generally, trusts are able to use the main home exception when a beneficiary of the trust uses the property as their main home.

However, trusts cannot use the main home exception where a principal settlor of the trust has another main home. This is to ensure that people cannot use the main home exception multiple times through the use of trusts.

Trusts – student flat

Dave has two properties, a family home which he lives in, and a student flat which his son lives in while studying. Dave settles the student flat on a trust and makes his son a discretionary beneficiary of the trust.

The trust cannot use the main home exception because the principal settlor of the trust (Dave) has another main home.

Deductions

Rental property

Carla has sold a rental property that is subject to the bright-line test.

May 2016: Carla buys rental property for $500k
May 2016 to 31 March 2017: Carla pays interest of $30k and rates of $5k
July 2016: Carla gets a new roof put on the building at a cost of $80k
2 April 2017: Carla sells the property for $800k

Deductions in 2016–17 year = $35k (interest and rates)
Deductions in 2017–18 year = $580k (Cost base of property = house and roof)
Income in 2017–18 year = $800k

Beach house

Denise has sold a private beach house that is subject to the bright-line test.

May 2016: Denise buys beach house for $500k solely for private use
May 2016 to 31 March 2017: Denise pays interest of $30k and rates of $5k
July 2016: Denise gets a new roof put on the building at a cost of $80k
*2 April 2017***:** Denise sells the beach house for $800k

Deductions in 2016–17 year = $0 – Interest and rates denied by the private limitation
Deductions in 2017–18 year = $580k (Cost base of property = house and roof)
Income in 2017–18 year = $800k

Ring-fencing

Losses from sales of residential property that are taxable solely due to the bright-line test are ring-fenced so they can only be offset against gains on other land sales.

Ring-fenced loss

In June 2017 Zac sells residential land that is taxable solely due to the bright-line test. Zac acquired the land for $600,000 and sold it for $540,000. For the 2017–18 income year, Zac also earned $80,000 in salary and wages.

The $60,000 loss for the sale of residential land is ring-fenced so that it may only be used to offset income from other land sales. Zac cannot use the $60,000 loss to offset his income from salary and wages.

Offsetting against future land gain

In August 2019 Zac sells land that he purchased with an intention of resale. Zac made a gain of $100,000 from the sale. Zac may offset his previous $60,000 loss against the $100,000 gain. As a result Zac only has to pay tax on $40,000 of the gain in the 2019–20 income year.

INHERITANCE

The Committee asked for further information on the provisions for inheritance in the bill.

Comment

When a person dies, their property may be sold or transferred to a beneficiary, who may subsequently sell the property. The bill proposes that those transfers and disposals will not be subject to tax under the bright-line test.

Background

When a taxpayer dies, an estate can be dealt with in several ways, depending on whether a will exists. A will usually provides for the appointment of one or more executors. In the absence of a will, a court will appoint someone to administer the deceased's estate (an administrator).

The executor or administrator is vested with legal and beneficial ownership of the deceased's property from the time of death to the end of the period of executorship or administration. The beneficiaries have a right to have the deceased's estate administered properly during this period but do not have a legal or beneficial interest in the assets.

The duties of the executor or administrator are to collect the assets of the deceased, pay all debts, testamentary expenses and taxes and to distribute the legacies. At the end of the period of executorship or administration, the executor or administrator becomes a trustee of the residual assets on behalf of the beneficiaries.

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 transfer to take 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.

Inheritance and the bright-line test

The bright-line test proposes rollover relief for all transfers following a death and an exemption for any disposals by the executor or administrator or subsequent disposals by the beneficiaries.

The rollover relief is achieved by deeming the transfers from the deceased person to the executor or administrator, and from the executor or administrator to the beneficiary, as a disposal and acquisition of the property at the total cost of the land to the deceased person at the date of transfer (rather than at the land's market value). The effect of this is that no tax liabilities under the bright-line test arise under the transfers.

Disposals by a beneficiary, executor or administrator of residential land transferred to them on the death of a person are specifically excluded from the bright-line test. However, the disposals may still be subject to tax under the current land sale rules.

CHANGES TO THE INTENTION TEST

The Committee asked whether there were any changes planned, or changes which could improve the current intention test as a result of the new bright-line test.

Comment

The bright-line test is intended to be a supplement to the intention test to assist with enforcement in cases where there is fast turnover of residential property.

We consider that the intention test is still necessary to ensure that speculators who hold their property for longer than two years are taxable on gains from their sales. As a result, the bright-line test is not intended to replace or alter the intention test. Officials are not currently proposing that any changes be made to the intention test.