NEW ZEALAND LAW SOCIETY

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TAXATION (BRIGHT-LINE TEST FOR RESIDENTIAL LAND) BILL

17/9/2015

SUBMISSION ON THE TAXATION (BRIGHT-LINE TEST FOR RESIDENTIAL LAND) BILL

1. The New Zealand Law Society (Law Society) appreciates the opportunity to comment on the Taxation (Bright-line Test for Residential Land) Bill (Bill). The Law Society is concerned about the short time frame available for making submissions on the Bill. A call for submissions was made on 9 September 2015, yet submissions are due on 17 September 2015. The Law Society notes that the Bill will not be enacted by 1 October 2015 (the effective date of the proposed bright-line test and related reforms) irrespective of the short time frame for making submissions, given that the Finance and Expenditure Committee (FEC) has a report back date of 22 October 2015. Accordingly, the Law Society recommends that the period for making submissions is extended so that proper consideration can be given to the proposed reforms.

The proposed bright-line test should not be enacted

Proposed bright-line test ineffective in achieving stated objective

2. The Commentary on the Bill[1] justifies the enactment of a two-year bright-line test for residential land on the basis that the "purpose or intention of disposal" test (section CB 6(1) of the Income Tax Act 2007 (the Act)) "is difficult to enforce due to its subjectivity". This is surprising, given that the burden of proof in such matters falls on the taxpayer and not on the Commissioner (section 149A(2) of the Tax Administration Act 1994). That is, if the Commissioner considers there is sufficient evidence to allege that a taxpayer has acquired land with a purpose or intention of disposal (sometimes referred to as discharging the "evidential burden"), the burden of disproving the Commissioner's allegation falls on the taxpayer.

3. The target of the proposed bright-line test appears to be those taxpayers who buy and sell land within a short period of time, but nonetheless maintain that the land was not acquired with a purpose or intention of disposal. It is doubtful, however, that the proposed bright-line test will satisfactorily address this issue. Speculators of the kind targeted by the Bill are likely to change their behaviour so that land is held for more than two years prior to disposal. Land owners most likely to be caught by the proposed bright-line test will be those taxpayers who need to dispose of property within two years of acquisition for reasons not contemplated at the time the land was acquired. Examples include:

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1 Taxation (Bright-line Test for Residential Land) Bill; Commentary on the Bill. ISBN 978-0-478-42414-0, August 2015. Available at http://taxpolicy.ird.govt.nz/sites/default/files/2015-commentary-bltrl.pdf.

- taxpayers whose personal situation has changed since acquiring the property;
- taxpayers whose employment has changed since acquiring the property, requiring them to relocate; and
- taxpayers whose financial circumstances have changed since acquiring the property.

4. Taxpayers who find themselves in one of these situations are presumably not the target of the proposed reforms, but are the ones most likely to be impacted. It is likely that the proposed bright-line test will subject the sale of land to tax where the taxpayer genuinely did not have a purpose or intention of disposal at the time of acquisition, but will not catch speculators who are currently not meeting their income tax obligations, as these taxpayers will simply change their behaviour so that land will not be disposed of within the two-year period.

5. Officials appear to acknowledge this concern in the Regulatory Impact Statement (RIS) on the proposed bright-line test. The table on page 6 notes that the two-year bright-line test is expected to raise only an additional $5 million per annum, once behavioural assumptions are factored in. Accordingly, officials are either asserting that non-compliance with the purpose or intention of disposal test is not a problem (in that the proposed bright-line test will generate only $5 million of additional revenue), or that the proposed bright-line test is ineffective in meeting its stated objective (being to ensure compliance with the existing purpose or intention of disposal test).

New property disclosure rules more effective in improving tax compliance

6. Officials also justify the enactment of the proposed bright-line test on the basis that the high volume of transactions involving residential property makes it difficult for Inland Revenue investigators to enforce the purpose or intention of disposal test (RIS, page 2). The new tax statement requirements set out in the Taxation (Land Information and Offshore Persons Information) Bill should ensure that Inland Revenue will have sufficient information to be able to enforce the land gain taxation provisions set out in sections CB 6 to CB 15 of the Act (not just the purpose or intention of disposal test in section CB 6(1) of the Act). The Law Society considers that the proposed disclosure rules will be much more effective in ensuring tax compliance in relation to land transactions than the proposed bright-line test which, as noted above, is much more likely to result in a change in the behaviour of land speculators than ensure compliance with the land gain taxation provisions.

Recommendation

7. The Law Society recommends that the proposed bright-line test should not be enacted. If officials are concerned about difficulties in enforcing the existing land gain taxation provisions, then the Law Society recommends that a comprehensive review of those provisions is undertaken, rather than reform being made on a piece-meal basis. The Law Society notes that most of the current land gain taxation provisions were enacted in 1973 and have not been reviewed since that time. A number of uncertainties arise from the application of the existing land gain taxation provisions, and the manner in which the existing land gain taxation provisions apply creates economic distortions. Both of these matters could be addressed in a comprehensive review of the land gain taxation provisions. The Law Society would welcome the opportunity to discuss these issues and possible solutions with officials.

Date of acquisition and disposal should be consistent with other taxation provisions

Date of acquisition should be the date the person acquires their first interest in land

8. Clause 4 of the Bill, which proposes the enactment of new section CB 6A of the Act, sets out a number of different rules for determining the date of acquisition and disposal of land depending on the circumstances. The proposed default rule is that the date of acquisition will be the date the purchase of the land is registered and the date of disposal will be the date the taxpayer enters into an agreement for the sale of the land.

9. There are already well-defined rules for determining the date of acquisition and disposal of land for the purpose of the current land gain taxation provisions (*cf* section CB 15B of the Act). Officials' reasons for introducing a new set of rules for the purpose of the proposed bright-line test are not compelling. The number and complexity of rules for determining the acquisition date of land for the purpose of the proposed bright-line test adds unnecessary complexity to the rules. As noted below, they will also be considered unfair by many taxpayers (as it will extend the bright-line period well beyond two years in many cases), and will likely lead to poor compliance with the proposed bright-line test.

Date of disposal should be determined consistently with the date of acquisition

10. It is not appropriate to have different rules for determining the date of acquisition and the date of disposal, particularly where transactions occur on an arm's-length basis. The manner in which the Bill proposes to determine the acquisition and disposal date will be considered unfair by many taxpayers, as it will have the effect of extending the bright-line period to more than two years in many cases. This will, in turn, adversely impact on taxpayer compliance with the proposed new rules.

11. The same rule should apply for determining the date of acquisition as for the date of disposal. That is, either the date of acquisition (and disposal) should be the date that the taxpayer acquires (and disposes of) the first estate or interest in the residential land, or the date of acquisition (and disposal) should be the latest date on which the person acquires (and disposes of) an estate or interest in the residential land.

12. The Law Society understands officials' concerns that setting the date of disposal as the date that the person disposes of their last estate or interest in land may give rise to avoidance opportunities and, for that reason, the Law Society considers that the date of acquisition (and the date of disposal) should be the date that the taxpayer acquires (or disposes of) the first estate or interest in the residential land. This is consistent with the approach taken under the other land gain taxation provisions.

Recommendation

13. The Law Society recommends that the date of acquisition for the purpose of proposed section CB 6A is defined as the date on which the person acquires the first estate or interest in the residential land, and that the date of disposal is defined as the date on which the person disposes of the first estate or interest in the residential land.

Main home exclusion should be clarified

Guidance should be provided on the dwelling with which a person has the greatest connection

14. The proposed definition of "main home" for the purpose of the proposed bright-line test (clause 15(9)) refers to the dwelling that is mainly used as a residence by the person and "with which the person has the greatest connection, if they have more than 1 home". The Commentary on the Bill (pages 12 and 13) states that the factors to determine this connection would be the same factors used to determine whether a dwelling is a person's "permanent place of abode" under the tax residence rules. Case law, including the recent *Diamond* case[2] (currently under appeal), illustrates that it may be difficult to apply this approach in practice. The Law Society recommends that Inland Revenue provides guidance on how these factors should be applied in a Taxation Information Bulletin following the enactment of the bright-line test.

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[2] *Diamond v Commissioner of Inland Revenue* (2014) 26 NZTC 21093.

Guidance should be provided on determining the principal settlor of a trust

15. The main home exclusion in proposed section CB 16A of the Act will apply where the property is held by a trust only if the "principal settlor" of the trust does not own a main home and, if the "principal settlor" of the trust is a beneficiary of a trust that owns the "principal settlor's" main home, it is that main home that is being disposed of.

16. Proposed section CB 16A defines the "principal settlor" as the settlor that has settled the most property, by value, on the trust. The definition of "settlor" for income tax purposes is extremely wide. It includes not only a person making cash settlements on a trust, but also persons making non-monetary transfers of value such as guaranteeing the trust's financial obligations and providing services to a trust for less than market value. In practice it may be difficult to value these non-monetary settlements.

17. In practice it may be difficult to determine who the "principal settlor" of a trust is in certain circumstances. Inland Revenue should provide guidance on how to determine the "principal settlor" where non-monetary settlements are made on a trust.

Guidance should be provided on exclusion of "farmland" from definition of residential land

18. The proposed bright-line test applies to the disposal of "residential land" (clause 15). The proposed definition of "residential land" excludes land that is used predominantly as business premises or as farmland. "Farmland", in turn, is defined as "land that because of its area and nature is capable of being worked as an economic unit as a farming or agricultural business".

19. The definition of "farmland", which is used in the farmland exclusion in section CB 21 of the Act, is not appropriate for the purpose of the proposed bright-line test. The meaning of the phrase "capable of being worked as an economic unit as a farming or agricultural business" is uncertain and, given the meaning ascribed to that term on page 9 of the Commentary on the Bill, could result in large tracts of rural land not being treated as farmland as it fails the "economic unit" test. Indeed, it is questionable whether many dryland farms are currently capable of producing any rate of return, let alone a rate of return that compensates for the cost of capital employed in purchasing that farmland along with a reasonable recompense for the proprietor's labour.

20. It appears that officials' main concern is that hobby farms and lifestyle blocks are not excluded from the bright-line test. If that is the case, it would be preferable for "farmland" to be defined as excluding a hobby farm or a lifestyle block, rather than referring to the "economic unit" test.

Recommendations

21. The Law Society recommends that:

(i) Inland Revenue provides guidance in a Taxation Information Bulletin on what factors will be taken into account in determining the dwelling with which a person has the greatest connection;

(ii) Inland Revenue provides guidance in a Taxation Information Bulletin on how to determine the "principal settlor" of a trust, particularly where non-monetary transfers of value (such as providing guarantees) are made; and

(iii) the definition of "farmland" is amended to exclude hobby farms and lifestyle blocks, rather than referring to the "economic unit" test; or, in lieu of that, Inland Revenue provides guidance in a Taxation Information Bulletin on when rural land will not be treated as farmland for the purpose of the proposed bright-line test.

Exclusion for transfers on death needs to be redrafted

Definition of "cost of residential land" poorly drafted

22. Proposed section CB 6A of the Act provides an exclusion for transfers of residential land on death. Proposed section FC 9(3) of the Act defines the cost of residential land for the purpose of providing rollover relief. Paragraph (b) of that definition refers to "all other expenditure incurred by the person, the deceased person, or the administrator or executor of the deceased person, as applicable, for which no deduction has been allowed".

23. On the face of it, the definition in proposed section FC 9(3)(b) would seem to include all expenditure incurred by the relevant person, whether or not it relates to the land in question, and whether or not that expenditure is capital expenditure (e.g. improvements) or revenue expenditure (e.g. rates, interest and insurance). Presumably, officials intend that only expenditure relating to the subject land is included in the cost of residential land, and that any accretions to the cost of the land must be capital in nature. If that is the case, then it is not reflected in the proposed definition of the cost of residential land.

Recommendation

24. The Law Society recommends that the definition of the cost of residential land in proposed section FC 9(3) be reworked so that expenditure included must relate to the subject land and that only expenditure of a capital nature is included.

Exclusions from bright-line test should be extended to corporate and personal insolvency

Exclusion for corporate and personal insolvency consistent with stated objective

25. The stated objective of the proposed bright-line test is to buttress the existing purpose or intention of disposal test. That is, the proposed bright-line test should apply only in circumstances in which it is presumed that the taxpayer must have had a purpose or intention of disposal at the time they acquired the property. This is presumably the reason why relationship property transfers and transfers arising as a consequence of the death of the taxpayer are excluded from the bright-line test. That being the case, the sale of residential land in the event of corporate and personal insolvency should also be excluded from the proposed bright-line test. In both of these instances, the taxpayer could not be presumed to have acquired land with the purpose that the land would be disposed of under a forced sale.

Recommendation

26. The Law Society recommends that the exclusions from the bright-line test be extended to include corporate and personal insolvency, as this is consistent with the stated objective of the proposed bright-line test, being to ensure that speculators comply with their income tax obligations.

Losses arising from proposed bright-line test should not be ring-fenced

Ring-fencing of losses inconsistent with scheme of the land gain taxation rules

27. Under the land gain taxation rules, where the sale of land is taxable the taxpayer is entitled to a deduction for the cost of that land. It is irrelevant that the cost of land may exceed the sale proceeds, giving rise to a tax loss. Officials acknowledge this is the correct outcome, as it ensures symmetry and avoids economic distortions. The Law Society agrees with this assessment, especially since it is consistent with the current law that the bright-line test is expressed to support by removing an evidential burden, and not to change the law relating to losses in a fundamental way.

28. Contrary to the above, proposed section DB 18A (clause 8) proposes that losses arising solely under the proposed bright-line test will be ring-fenced, so that they can only be offset against gains on other land sales that are subject to income tax under the land gain taxation provisions. The

justification appears to be that the ability to claim losses provides an incentive for taxpayers with unrealised losses to bring forward the sale of that property so that it falls within the two-year bright-line period, and that taxpayers with unrealised gains will seek to defer the sale of property until after the two-year bright-line period.

29. No such restrictions apply under any of the so-called 10-year sale rules that apply to the sale of land. For example, a taxpayer who holds land that is “tainted by association” with a dealer, developer or builder could choose to dispose of that land (including to an associated person) within the 10-year period to crystallise a loss, but seek to defer the sale of that land beyond that 10-year sale period if the taxpayer has an unrealised gain. It makes no sense, therefore, to apply a different rule for the purpose of the bright-line test.

30. No ring-fencing of losses should apply under the bright-line test, as it creates an economic distortion in that gains and losses are not taxed symmetrically, and is inconsistent with the scheme of the other land gain taxation provisions. It could also lead to behaviour inconsistent with the apparent purpose of the reforms, if taxpayers sought to sell property simply in order to utilise ring-fenced losses.

Deduction should be allowed for all expenses not solely related to private use of dwelling

31. Officials have previously advised that where the sale of land is subject to income tax under the proposed bright-line test, but that land has not been used to derive income (e.g. a bach), deductions will not be allowed for holding costs. By way of example, officials have previously advised that interest (unless incurred by a company), rates, insurance and repairs and maintenance would not be deductible in this instance.

32. The Commentary to the Bill (page 20) states that holding costs will be treated as being of a private nature if they are exclusively related to “living as an individual”. The Law Society agrees with this assessment. However, the Commentary to the Bill then states that holding costs such as interest, insurance, rates and repairs and maintenance would be exclusively related to “living as an individual” where the property is not used to derive income.

33. The Law Society does not agree that holding costs, such as interest, insurance and rates exclusively relate to “living as an individual” (and, therefore, subject to the private limitation), as those costs would be incurred whether or not the property was used or available for use for private purposes. That is, most holding costs would be incurred irrespective of any private use of the subject property. The Law Society recommends that Inland Revenue provide further guidance on this point in a

forthcoming Taxation Information Bulletin on the bright-line test, especially since this aspect of the new rules appears to be a departure from the existing law, and not strictly necessary in order to implement the new bright-line test.

Effective date of deduction cap should be consistent with other proposed reforms

34. Clause 8(2) of the Bill provides that the proposed loss ring-fencing rules will apply to residential land acquired “after 1 October 2015”. The effective date should be “on or after 1 October 2015” to be consistent with the other proposed reforms.

Recommendations

35. The Law Society recommends that:
    (i) the proposed ring-fencing of losses rules not be enacted as they are unnecessarily inconsistent with the scheme of the Act and the other land gain taxation provisions, and will create economic distortions; and
    (ii) where residential land is taxed under the bright-line rule, a deduction should be allowed for all expenses relating to that property that do not solely relate to the private use of the dwelling, which will include most holding costs.

Proposed specific anti-avoidance rules should not be enacted

Proposed specific anti-avoidance rules not justified

36. Clause 14 of the Bill proposes the introduction of a specific anti-avoidance rule for land-rich companies (proposed section GB 52) and land-rich trusts (proposed section GB 53). The Law Society does not agree with the enactment of a specific anti-avoidance rule relating to the transfer of shares in a land-owning company, and notes that such a rule is not necessary in the context of a land-owning trust.

37. The Law Society questions the likelihood of the vast majority of taxpayers acquiring shares in a company as a means of acquiring residential land. The acquisition of shares carries the risk of exposure to other liabilities and is not a commercially viable way of acquiring residential land. Further, it is unlikely that the sale of shares in a land-rich company will be practical, given the securities law obligations that arise.

38. In short, the small number of land transactions that could be expected to be effected via the change in control of a land-owning company or a land-owning trust does not support the introduction of a specific anti-avoidance rule. Further, if a taxpayer acquires property in a company for the dominant

purpose of disposing of those shares, the sale of the shares is likely to be subject to income tax under section CB 3 of the Act (profit-making undertaking or scheme) in any event.

39. The Commentary on the Bill (pages 22 to 23) states that the specific anti-avoidance rules will not apply where a transaction (e.g. the disposal of shares) "… viewed in a commercially and economically realistic way, makes use of the bright-line test provisions in a manner that is consistent with Parliament's contemplation". This is, in essence, the test that currently applies under the general anti-avoidance provision (section BG 1 of the Act). Accordingly, the Law Society questions why additional specific anti-avoidance provisions should be enacted to deal with a perceived risk that is already covered by the general anti-avoidance rule.

Proposed specific anti-avoidance rules could lead to over-taxation

40. The proposed specific anti-avoidance rule for land-rich companies in proposed section GB 52 applies where 50% or more of the shares in a land-rich company (as defined), by value, are disposed of within a 12-month period, with a purpose or effect of defeating the intent and application of the bright-line test. Where the specific anti-avoidance rule applies, a shareholder will be treated as disposing of the company's residential land "… for an amount of consideration equal to the proportion of the market value of the land that the market value of their shares bear to the total value of the shares in the company".

41. This means, for example, that the sole shareholder of a company will be treated as having disposed of all of the residential land owned by that company where that shareholder disposes of 50% or more of their shares to a third party. Given that the shareholder would still retain ownership of up to 50% of the shares in the company, this could give rise to over-taxation, and lead to economic distortions.

Proposed criteria for land-rich trusts flawed

42. The criteria for triggering the specific anti-avoidance rule for land-rich trusts under proposed section GB 53 of the Act is unclear. That criteria refers to changes in "an arrangement under the trust". It is not clear what "an arrangement under the trust" is. The Law Society is concerned that officials could treat almost any arrangement as "an arrangement under the trust" for the purpose of invoking the specific anti-avoidance rule.

Recommendations

43. The Law Society recommends that:

(i) the proposed specific anti-avoidance rules for land-rich companies and land-rich trusts are not enacted, as officials' concerns relating to the avoidance of the proposed bright-line test are overstated and, in any event, these concerns are adequately addressed by existing taxation rules (e.g. section CB 3 of the Act) and the general anti-avoidance provision;

(ii) the deemed disposal rule in proposed section GB 52(2) of the Act be redrafted to ensure that the deemed disposal does not give rise to over taxation where a shareholder does not dispose of all of their shares in the subject company; and

(iii) the criteria for determining when the specific anti-avoidance rule for land-rich trusts applies in proposed section GB 53(1)(c) is amended to ensure that the criteria is clear and unambiguous, and does not refer to changes in "an arrangement under the trust".

Criteria for trusts to be excused from filing tax returns should be clarified

Inland Revenue should provide guidance on when trusts are required to file tax returns

44. Trusts that are "taxpayers" are required to file an income tax return and must obtain an IRD number for this purpose. However, 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.

45. The proposed reforms set out in the Taxation (Land Information and Offshore Persons Information) Bill will require such trusts to obtain an IRD number when they buy or sell land. This will require those trusts to file an income tax return unless they are treated as a non-active trust. However, trusts that do not currently have an IRD number because they do not derive income, and are not required to obtain an IRD number because they have not bought or sold land on or after 1 October 2015, should not be required to obtain an IRD number and file income tax returns.

Definition of non-active trust should be amended

46. The criteria for non-active trusts to be excused from filing income tax returns in proposed section 43B of the Tax Administration Act 1994 (clause 16) is based on the criteria that currently applies to non-active companies. However, some of those requirements should not apply in determining whether a trust is a non-active trust. In particular, while the requirement that the non-active entity has not disposed of any assets may be relevant in the company context (as a distribution of those sale proceeds may be treated as a dividend for income tax purposes), that is not the case for a complying trust (as distributions of capital by a complying trust are not subject to income tax).

47. Given that the proposed definition of non-active trusts is restricted to complying trusts (proposed section 43B(1)(a)(ii)), it should not be necessary for the criteria set out in proposed section 43B(2)(c) to be included. That is, a trust should only cease to be a non-active trust if it derives taxable income or incurs allowable deductions, and not simply because it has disposed of (or deemed to have disposed of) any assets. Retaining the requirement that the trust has not disposed of or deemed to have disposed of any assets of the trust will unnecessarily increase compliance costs, but not increase the tax take.

Recommendations

48. The Law Society recommends that:

(i) Inland Revenue confirms 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; and

(ii) the proposed definition of a non-active trust in proposed section 43B(2) of the Tax Administration Act should be amended to exclude the requirement that the trust has not disposed of (or deemed to have disposed of) any assets of the trust, as this will unnecessarily increase compliance costs without increasing the tax take.

Conclusion

49. The Law Society wishes to appear in support of these submissions. Alternatively, the Law Society is willing to meet with the officials advising on the Bill if the Committee considers that would be of assistance.

Chris Moore
President

17 September 2015