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27 July 2015

Bright-line test for sales of residential property
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Bright-line test for sales of residential property: an officials' issues paper, June 2015

Introduction

1. The New Zealand Law Society (Law Society) appreciates the opportunity to comment on *the Bright-line test for sales of residential property: an officials' issues paper, June 2015* (issues paper). Following some general comments relating to the proposals, the Law Society comments on the specific content of the issues paper.

2. Statutory references are to the Income Tax Act 2007 (the Act) unless otherwise specified.

General Comments

3. Officials justify the introduction of the two-year "bright-line" test for residential property on the basis that the purpose or intention of the disposal test (section CB 6(1)) "can be difficult to enforce due to its subjectivity" (paragraph 1.3). This is surprising, given that the burden of proof in such matters falls on the relevant taxpayer and not the Commissioner (section 149A(2) of the Tax Administration Act 1994). That is, if the Commissioner considers there is sufficient evidence to make an allegation that a taxpayer has acquired property with a purpose or intention of disposal (sometimes referred to as discharging the "evidential burden"), the burden of disproving that the Commissioner's allegation falls on the taxpayer.

4. The target of the proposed bright-line test appears to be those taxpayers who buy and sell a property within a short period of time but nonetheless maintain that the property was not acquired with a purpose or intention of disposal. It is doubtful, however, that the proposed bright-line test will solve this issue. Property speculators of the kind targeted by the issues paper are likely to change their behaviour so that property is held for more than two years prior to disposal. The property owners most likely to be caught by the new 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 property was acquired. Examples include:

- 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.

5. 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 the proposed bright-line test will subject property sales to tax where the taxpayer genuinely did not have a purpose or intention of disposal at the time of acquisition, but will not catch property speculators who are currently not meeting their income tax obligations, as these taxpayers will simply change their behaviour so that property will not be disposed of within the two-year period.

6. On a related point, there is a risk that the two year bright-line test will operate at a practical level as something of a threshold, beyond which property transactions that might be caught by the purpose or intention of disposal test in section CB 6 are not pursued through audit. If the bright-line test became the rule (in a practical sense), the perverse result could be that property speculators who can afford to hold property beyond two years will (possibly) not be taxed, whilst those who acquire property without a purpose or intention of resale but who are compelled to sell the property within two years will be taxed.

Specific Comments

Chapter 3: Dates of acquisition and disposal

7. Chapter 3 proposes different sets of rules for determining the date of acquisition and the date of disposal depending on the circumstances. The proposed default rule is that the date of acquisition will be the date the purchase of the property is registered and the date of disposal will be the date the taxpayer enters into an agreement for sale and purchase to sell the property.

8. There are already definitions and case law surrounding the date of acquisition and disposal of land under the existing taxation rules. There does not seem to be a clear rationale for introducing a new set of rules and definitions. Nor does it seem appropriate to have a different rule for the date of acquisition as compared to the date of disposal, particularly when the transaction is at arm's length. If a person was involved in a series of transactions then they would be caught under the existing real property tax provisions.

9. The reason given (paragraph 3.3 of the issues paper) for changing the acquisition date from the date that a person enters into a sale and purchase agreement to the date of registration, is to avoid uncertainty in circumstances where the seller may not have access to the original sale and purchase agreement because different lawyers were used for the purchase and subsequent sale.

10. However, as lawyers are obliged to retain all records for periods in excess of two years, there is no reason information in relation to the date of the agreement cannot be exchanged, even

if a different lawyer is used for the subsequent sale. The Law Society does not agree that using the date of the agreement to purchase as the date of acquisition would create uncertainty, and considers that the timing of the acquisition should be the point at which the purchaser gains a legal right to the property. This should also be the case for the transitional rules (outlined at paragraph 3.13).

11. The date of acquisition could coincide with the date the conditions subsequent are confirmed (if the equitable estate passes to the purchaser). However, this may lead to complications in the event of cancellation.

12. With regard to the date of disposal (paragraph 3.5), it should be made clear that the date of an agreement to sell as the date of disposal will only operate if the settlement actually occurs.

13. The issues paper proposes that different rules will apply where the disposal does not involve an agreement for sale and purchase (for example, where the property is transferred by way of gift) or where the right to purchase the property[1] is disposed of prior to the date of registration. None of these rules is consistent with the current rules for determining when property is acquired and disposed of. Paragraph 1.6 states that the bright-line test will "use existing rules and tax law where possible". Clearly, this is not the case in determining when property is acquired or disposed of. Rather than creating certainty, there is a substantial risk that the proposed bright-line test will create further uncertainty for taxpayers and their advisors, given the range of dates that could be treated as the date of acquisition or disposal for different purposes.

14. Paragraph 3.10 identifies the need for an additional rule for sales of the right to buy property. The Law Society notes that the rules around nominations to associated parties (for example, from an individual to a family trust) should be clarified.

15. Feedback has been invited on how the bright-line test should apply to disposals that occur as a result of individual or corporate insolvency (paragraph 3.14). In terms of individual insolvency, the same exclusions should apply that are proposed to apply for property transferred on the death of a person. That is, the transfer of property from the bankrupt individual to the Official Assignee should be at cost, and the subsequent sale by the Official Assignee should be exempted from the bright-line test. Like death, personal bankruptcy is unlikely to have been anticipated at the time the property is purchased, and the Official Assignee can be likened to the executor of a deceased's estate in that the Official Assignee has no choice but to acquire the property. This is consistent with the justification provided at paragraph 6.35 for the difference in approach between transfers on the death of a person and transfers under a relationship property agreement.

16. Similar considerations apply in respect of corporate insolvency although the property would remain in the company's ownership (the liquidator merely assuming rights to control decision-making in relation to the property). The disposal of property at the direction of the liquidator is (as far as the company's owners are concerned) involuntary or compelled and ought to be

[1] Assuming that is an interest in land – which is probably not the case if the right is transferred before the taxpayer acquires an interest in the land (as opposed to a contractual right).

excluded on similar grounds to property transferred on death or the dissolution of a relationship.

Chapter 4: Definition of "residential land"

17. Paragraph 4.3 proposes that the definition of "residential land" be land that has a dwelling on it or land for which there is an arrangement to build a dwelling on it, but does not include land that is used predominantly as business premises or as farmland. The exclusion should refer to land that is used "mainly", rather than "predominantly", as business premises or as farmland. The word "mainly" is used throughout the Act for consistency and uniformity of interpretation. The word "predominantly" is referred to in only two places in the Act, being the current definition of "dwelling" (which was carried over from the (now repealed) definition of "dwelling" in the Goods and Services Tax Act 1985), and in the definition of "community housing entity" in section CW 42B(2). It is not clear whether the rules apply to residential sections if there is no particular arrangement to build.

18. The suggested definition of "business premises" as "land that is the premises of a business" (paragraph 4.7) appears unnecessary as it does not illuminate the meaning of the general term in any (or any material) way. The Law Society questions whether the definition is required.

19. The suggested definition of "farmland" is "land where the area and nature of the land disposed of means that it is then capable of being worked as an economic unit as a farming or agricultural business" (paragraph 4.8). This definition, which is used in the farmland exclusion in section CB 21, is not appropriate for the purpose of the proposed bright-line test. 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 in footnote 5 on page 12 of the issues paper, could result in large tracts of land which clearly is farmland not being treated as farmland for the purpose of the bright-line test because it fails the 'economic unit' test. Indeed, it is likely that most farmland is not capable of producing 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. It would be preferable for the term "farmland" either to be left undefined, or defined as excluding a lifestyle block (since that seems to be the main reason for seeking to define "farmland").

20. If "farmland" is to be defined, care will also need to be taken as the dwelling house associated with a farm may be on a separate or small title which is not "capable of being worked as an economic unit as a farming or agricultural business" but is clearly associated with an economic farm. Any exception should include land which when disposed of forms part of an economic unit for farming/agricultural purposes (i.e. small areas acquired by and incorporated into neighbouring farming operations).

21. With regard to paragraphs 4.9 – 4.11, some care will need to be taken with the definition of "an interest in land" in that the exceptions will need to be broader than simply a mortgage.

Chapter 5: "Main home" exception

22. Paragraph 5.5 proposes that, if the property is owned by a trust, the "main home" exception will apply when the dwelling is occupied mainly as a residence by a beneficiary of the trust, and is the main home of the beneficiary of the trust. Paragraph 5.6 goes on to say that if "the"

settlor of the trust has a main home that is not owned by the trust, it is proposed that the main home exception cannot apply to any property owned by the trust. Paragraphs 2.8 and 5.12, on the other hand, state that if "a" settlor of a trust has a main home that is not owned by the trust, then the main home exception cannot apply to any property owned by the trust.

23. The proposed wording for the bright-line test and the main home exception in the Appendix to the issues paper does not define what "settlor" means for this purpose. Presumably, the expansive definition in sections HC 27 and HC 28 will apply. That being the case, many family trusts will have a number of settlors, with the result that it is unlikely the main home exception will ever apply where a residential property is owned by a trust. The mischief that officials are trying to prevent seems to be where the "main" settlor of the trust owns their main residence outside of the trust (see paragraph 5.12). That being the case, it would make sense if the definition of "settlor" was limited for the purpose of proposed section CB 16A, so that if there is more than one settlor of the trust, "the settlor" is the main settlor (who, presumably, would be the person responsible for the highest transfer of value to the trust).

24. A further qualification is necessary to ensure that a trust is entitled to rely on the main home exception if the main settlor is not also a beneficiary of the trust or does not otherwise have an interest in the proceeds of sale. A settlor may make a gift on trust for the benefit of children or other family members (for example), without retaining any interest in the property as a beneficiary or creditor. The disposition of that property would not involve the main settlor being entitled to the benefit from a second main home exception. The existence of a settlor that maintains a main home but does not have any interest in the property held on trust should not disqualify the trust from the main home exception.

25. Paragraph 5.10 states that where a person has several residences, their "main home" is the property with which they have the greatest connection. Paragraph 5.10 goes on to state 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 (currently under appeal), illustrates that it may be difficult to apply this approach in practice.

26. Paragraph 5.11 notes that a significant number of family homes in New Zealand are owned by family trusts. While that is true, some family homes are also owned by look-through companies and qualifying companies (particularly where the family home is part of a lifestyle block). It would be helpful if officials clarified that the main home exclusion will apply where a family home is owned by a look-through company (as a consequence of the fiscal transparency provisions in section HB 1(4)). Also, it could be worth pursuing the possibility that the main home exclusion be extended to situations where the main home is held by a qualifying company.

27. As family trusts grow in assets over time, a trust may legitimately own more than one "main home" – where, for example, a number of second generation beneficiaries may live in individual properties all owned by the trust. The proposed legislation could differentiate between minor beneficiaries and adult beneficiaries. There is already a precedent for this in terms of the association rules in that adult children are not associated with their parents. In addition, the broad definition of "settlor" could cause significant issues (paragraphs 5.11 – 5.12).

28. Thought should also be given to the position of a foreign owner of property who maintains several homes around the world, including in New Zealand. That property might not have been acquired with any view to deriving gains on disposition but only to act as the owner's base when in New Zealand. The Law Society recommends that consideration be given to whether the main home test should focus on the "main home in New Zealand".

Chapter 6: Exceptions for inherited property and relationship property

29. The Law Society agrees with the proposal that the transfer of property under a relationship property agreement be at cost for income tax purposes, and that any subsequent transfer of that property by the transferee will be subject to the bright-line test only if that property is disposed of within two years of the date that the transferor acquired the property.

30. The Law Society also agrees with the justification for the difference in approach between transfers on the death of a person and transfers under a relationship property agreement set out in paragraph 6.35. In essence, the distinction centres on whether the acquisition of the property by the transferee is a passive acquisition of property.

31. Family homes are commonly held in trust and may also be disposed of to associated parties as a result of a relationship property agreement (for example to another trust). Those transfers should be looked through, with the date of acquisition by the transferee being deemed to be the date the property was first acquired by the transferor (paragraphs 6.31 – 6.33).

32. In relation to land transferred as relationship property under a relationship property agreement, that land is not always the subject of a choice in that property divisions are often quite stressful and difficult to deal with. In addition, parties are not always able to maintain their share of assets and debt following a relationship property division. It may be appropriate to include a hardship provision in this instance where the "main home" is acquired but then has to be disposed of. The joint intention of the parties may have been to hold the home for some years but individually they cannot maintain the asset (paragraph 6.35).

Chapter 7: Deductions

33. Officials propose an apportionment of property holding costs between those that are private in nature and those that are not (those being referable to private purposes being non-deductible under the private limitation). It is accepted at paragraph 7.8 that where a property is rented out by its owner without any element of private use, holding costs are likely to be deductible.

34. This outcome is unsatisfactory. The proposed bright-line rule treats property as revenue account property. Holding costs such as rates and insurance are obligatory expenditures (or close to it) without connection to the use of the property for private or other purposes. Likewise, repairs and maintenance are not dependent on the use of the property to derive rental or for private purposes. The holding costs of revenue account property ought to be deductible expenditure. The cost of acquisition and holding costs are necessary expenditures to derive income under the bright-line rule.

Chapter 8: Treatment of losses

35. Paragraph 8.1 notes that, under the current land sale rules, where the sale proceeds are taxable, the taxpayer is entitled to a deduction for the cost of the property without limitation. As such, it is irrelevant that those costs may exceed the sale proceeds. Paragraph 8.2 acknowledges that this is the correct outcome, as it ensures symmetry and avoids economic distortions. The Law Society agrees with this assessment.

36. Paragraph 8.3, however, states that the unrestricted ability to use losses arising from the application of the bright-line test creates a tax risk. Paragraph 8.3 asserts 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. It is fair to question whether taxpayers would actively seek to accelerate the generation of losses through sale, but this is the case in any event under the existing land gain taxation provisions. For example, a taxpayer who holds property that is "tainted by association" with a dealer, developer or builder could choose to dispose of that property (including to an associated person) within the 10-year period to crystallise a loss, but seek to defer the sale of that investment property 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. No ring-fencing of losses should apply under the bright-line test, as it creates a distortion in that gains and losses are not taxed symmetrically (a point that is acknowledged in paragraph 8.7 of the issues paper).

37. The Law Society agrees with the policy for not recognising losses under the bright-line test where property is transferred between associated persons. However, it is noted that such a rule does not generally apply to other transfers of revenue account property between associated persons (with the exception of section CB 15(1)).

38. With regard to paragraphs 8.9 – 8.10, if losses between associated parties are not to be recognised, the associated purchaser should be entitled to benefit from the date of acquisition of the associated vendor.

Chapter 9: Land-rich companies and trusts

39. 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.

40. The Law Society questions the commercial likelihood of the vast majority of purchasers of property acquiring shares in a company as a means of acquiring land. The acquisition of shares carries risk to exposure to other liabilities that may jeopardise clean ownership of the property. The transaction costs to address these risks may be significant. Other practical problems suggest that sales of shares in land-rich companies will not become prevalent. The sale of shares through an open market process (listings in the Property Press) may carry securities law obligations for the vendor, just by way of example. In short, the small number of land transactions that can be expected to be effected through this means does not seem to support the introduction of a specific anti-avoidance rule.

41. If a taxpayer acquires property in a company for the purpose of selling the shares in that company, the sale of the shares is likely to be subject to income tax under section CB 3 of the Income Tax Act 2007 (profit-making undertaking or scheme) in any event. The manner in which officials propose to draft the specific anti-avoidance provision, in conjunction with the example set out on page 30 of the issues paper, implies that the transfer of shares in a company that owns residential land will always be caught by the specific anti-avoidance rule. That should not be the case. The interpretation and application of specific anti-avoidance rules which refer to "the effect of defeating the intent and application of" a particular taxation regime is complex (refer to the differing views in the High Court, Court of Appeal and Privy Council in the *Auckland Harbour Board* case), and the Law Society is concerned that IRD auditors will simply apply an effect-based test without considering the other aspects of the specific anti-avoidance rule (which has happened in respect of the application of similar specific anti-avoidance rules).

Drafting Issues (Appendix)

42. The Appendix sets out proposed drafting for new sections CB 6A (disposal within 2 years: residential land) and CB 16A (main home exclusion). Proposed section CB 6A refers to the situation where a person "enters into an agreement for the disposal of the residential land within two years" of the applicable date. Proposed section CB 6A does not, however, require a connection between the particular agreement for sale and purchase and the amount derived from disposing of the land. That is, based on the proposed wording of section CB 6A, the sale of land held for more than two years could conceivably be caught by the bright-line test if the taxpayer entered into an agreement for sale and purchase within two years of the date the land was acquired, that agreement was subsequently cancelled, and a new agreement was entered into, say, 25 years after the date of acquisition. Section CB 6A should be redrafted to make it clear that it applies only in respect of an amount that a person derives from the disposal of residential land under an agreement for the disposal of that land within two years of the date that land was acquired.

43. Proposed section CB 16A sets out the main home exclusion to the bright-line test. Paragraph (b) refers to "the settlor" of the trust. As noted above (submissions on Chapter 5), a trust will frequently have a number of settlors (due to the wide definition of "settlor" in sections HC 27 and HC 28) and, accordingly, it is not clear how the proposed main home exclusion will apply (if it applies at all) where a family home is held by a family trust with more than one settlor. One way of addressing this point is to redraft proposed section CB 16A(b) to refer to the "main settlor of the trust". A further qualification could be introduced to address situations where the settlor does not maintain any interest in the property sold by the trust.

44. The Appendix also sets out proposed definitions of key terms. These have already been commented on above, and for ease of reference the comments are summarised below. Officials are also referred to the Law Society's recent submission on the Taxation (Land Information and Offshore Persons) Information Bill (Bill), which is **attached**. For the avoidance of doubt, the Law Society's comments on relevant definitions in the Bill (i.e., "dwelling", "main home" and "residential land") also apply in respect of those terms in the issues paper.

45. The proposed definition of "dwelling" in the Appendix refers to any place used "predominantly" as a place of residence or abode. As noted above (submissions on Chapter 4),

the word “predominantly” is no longer generally used in drafting tax legislation and the use of the word “mainly” should be used for consistency and certainty of interpretation.

46. The proposed definition of “farmland” should be deleted or, if it is retained, should not refer to land capable of being worked as an economic unit, as that would result in genuine farmland being excluded. Rather, the definition could simply exclude a lifestyle block (given that officials intend that the bright-line test should apply to lifestyle blocks).

47. The proposed definition of “main home” refers to the home “with which the person has the greatest connection”. As noted in the Law Society’s submission on the Bill (paragraphs 7 – 10), that phrase is likely to give rise to uncertainty. If the expression “main home” is to be retained, the Law Society recommends that a definition similar to section 3(1)(e) of the Joint Family Homes Act 1964 be used (such as, ‘main home’ means for a person the home which is used as the exclusive or principal residence of the person). In addition, if it is retained, guidance should be provided in a Tax Information Bulletin on the factors (listed in paragraph 5.10) Inland Revenue will take into account in determining which residence a person has the greatest connection with.

48. Paragraph (b) of the proposed definition of “residential land” refers to land that is used “predominantly” as business premises or as farmland. As noted above, the word “predominantly” is not generally used in drafting tax legislation, and the word “mainly” should be preferred (as currently used in the business premises exclusion in section CB 19 and the farmland exclusion in section CB 21).

Conclusion

49. This submission was prepared with assistance from the Law Society’s Tax Law Committee and Property Law Section. If you wish to discuss this further, please do not hesitate to contact the Tax Law committee’s convenor Neil Russ, through the committee secretary Jo Holland (04 463 2967 / jo.holland@lawsociety.org.nz).

Yours sincerely

Chris Moore
President

Attached:
NZLS submission on the Taxation (Land Information and Offshore Persons) Information Bill, 9.7.15