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Holding costs for privately used land that is taxable on sale
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
Wellington

By email: policy.webmaster@ird.govt.nz

Tax policy consultation – Holding costs for privately used land that is taxable on sale

1. The New Zealand Law Society (Law Society) welcomes the opportunity to submit on the proposals in the tax policy consultation document: *Holding costs for privately used land that is taxable on sale* (Paper).
2. The Paper considers the situation where land which will be[1] (or becomes[2]) taxable on sale is privately used (in part or in whole) prior to sale. The paper recognises that there are, broadly, three options:
   a. Full deductibility of holding costs;
   b. Apportionment of holding costs between private use and taxable gain;
   c. Denying any deduction for periods of private use, based on the proportions in the year of disposition of the land[3].
3. The Paper:
   a. Recognises that an apportionment approach would "arguably" be the most accurate option[4];
   b. Says apportionment would not be consistent with other areas of New Zealand's tax law where no apportionment is required[5];
   c. Says apportionment would be difficult to calculate and/or administer[6]; and
   d. Says that a simplified apportionment (e.g. 50%) would be arbitrary[7];
4. Therefore the Officials' current view is that denying deductions for all holding costs for periods of private use is the best option.[8]
5. The Law Society disagrees with this view, and submits that apportionment:

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1 For example, because the taxpayer bought the land with intention of resale.
2 For example, because the taxpayer falls under the bright-line rule or the various ten-year rules.
3 *Holding costs for privately used land that is taxable on sale at* [2.10].
4 Ibid at [1.12], [2.5].
5 Ibid [1.12], [2.6].
6 Ibid [2.5].
7 Ibid.
8 Ibid [1.13].

a. Is consistent with current legislation and well-established case law; and

b. Need not be difficult to calculate or administer.

6. The Law Society notes that, as recognised in the Paper[9], there is an existing regime to determine deductibility of land held and used for mixed private and income-earning use, (the mixed-use asset rules in Sub-part DG of the Income Tax Act 2007 (the Act). Whatever approach to deductibility of holding costs on a taxable sale is adopted, it should be clarified that:

   a. That approach does not override the mixed-use assets rules.

   b. There is no double deductibility, i.e. a deduction otherwise allowable under the approach to deductibility of holding costs on a taxable sale is not allowable if that expenditure has already been allowed in part under the mixed-use assets rules.

7. The Paper considers[10] whether different rules should apply where the land in question is purchased through a non-human entity, e.g. a company. The Law Society agrees with the Officials' view[11] that as there are already rules which disincentivise company ownership of privately used land, no further rules specific to the issue covered by the Paper (which differentiate among different ownership structures) are presently warranted, but this is an area which should be monitored further.[12]

8. The Law Society agrees with the Paper's conclusion on the treatment of periods of vacancy, that the mixed-use assets rules should continue to apply.[13]

9. The Paper also considers[14] whether amendments to section DB23 of the Act are needed to ensure that any deductions of holding costs on a taxable sale are not excluded by the general permission or the private limitation, and concludes that they would be desirable. We agree with this conclusion.

10. Accordingly we now address

    a. Apportionment vs denial of deductibility for periods of private use in year of sale;

    b. Clarification of the interface with the mixed-use asset rules.

Problems with denial of deductibility for last-year private use

11. The Law Society observes that the cost, including the holding costs, of revenue account land are deductible in the year of sale, unless some supervening provision applies (for example the land is used to derive income while it is held). That must continue to be the case for land that becomes taxable under the bright-line test, especially as the purchaser of such land may not know until sale that it comes within the tax net. Consequently:

    a. Officials' proposal to deny a deduction for holding costs based on the proportion of private use in the year of sale is arbitrary and open to gaming: a taxpayer may hold land for resale, choose to live on it privately for four years and sell it in the fifth year, and rent it for the entire fifth year. In that case all the holding costs would be deductible even though the land was used privately for most of the holding period.

    b. The proposal to deny a deduction for holding costs based on the proportion of private use in the

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9 Ibid [3.2].
10 Ibid [2.18] to [2.23].
11 Ibid [2.22].
12 Ibid [2.23].
13 Ibid [Chapter 3].
14 Ibid [Chapters 4 and 5].

year of sale would also run across the mixed-asset rules in many cases. If, in the last year of sale, the land were privately held for 120 days, rented for 120 days and sold on the 241st day, then the mixed-asset rules would look after deductibility apportionment in any event.

Apportionment consistent with legislation and case law

12. The legislation reflects a general policy of apportionment of expenditure between private use and taxable activity. Sub-part DG of the Act is a paradigm example.

13. Since *Banks*[15] at least, the Courts have consistently held that a taxpayer may apportion mixed-use expenditure between private and revenue-earning portions. There is no difference in principle between apportioning holding costs of a house based on area which is used for business versus private use and apportioning it on the basis of the private versus taxable benefits derived.

Method of apportionment

14. Apportionment of holding costs may be easily and fairly implemented as follows:

    a. Where the mixed-use assets rule has been applied to allow a deduction for expenditure of holding costs, that expenditure is no longer available for deduction in whole or part against the gain on sale of land;

    b. Otherwise, deductibility of the holding costs during the period over which the taxpayer held the land should be apportioned according to the proportion of the taxpayer's private benefit against the taxable gain of the land;

    c. The taxpayer's private benefit can be judged by the market rental(s) attributable to the land during the period(s) of private use; and

    d. As always, the onus is on the taxpayer to quantify, corroborate and if necessary prove such figures.

15. To illustrate, for a taxpayer who bought land for private use for $1m, lived in it while it had a total market rent of $200,000, incurred $300,000 of holding costs (interest, rates, insurance, etc) but then sold it after four years for $2m, the calculation would be:

    a. Gain on sale $1m ($2m - $1m);

    b. Private benefit $200,000 (market rental);

    c. Portion of taxable to total benefit 5:6 ($1,000,000/$1,200,000);

    d. Holding costs deductible $250,000 (5/6 x $300,000).

16. The only aspect of the exercise above which is not unequivocally quantifiable is the market rental. However, this need not be a barrier, as:

    a. Increasingly, online algorithms are available to assist in determining this; and

    b. As above, the onus of proof rests on the taxpayer.

Interface with mixed-use assets rule

17. Expenditure on which a deduction has been allowed under the mixed-use assets rule should not be available for deduction in whole or in part against the gain on sale of land.

Conclusion

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15 *Commissioner of Inland Revenue v Banks* [1978] 2 NZLR 472 (CA).

18. We trust Inland Revenue will find these comments helpful. If you wish to discuss the comments, please do not hesitate to contact the Tax Law Committee convenor Neil Russ, through the Law Society's Law Reform Adviser, Emily Sutton (Emily.Sutton@lawsociety.org.nz).

Yours faithfully

Herman Visagie
Vice President