

Bright-line test for sales of residential property

An officials' issues paper

June 2015

Prepared by Policy and Strategy, Inland Revenue, and the Treasury

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CHAPTER 1

Introduction

- 1.1 As part of Budget 2015, the Government announced that it would introduce a “bright-line” test for the sale of residential property. The test will require income tax to be paid on any gains from the sale of residential property that is bought and sold within two years, with the exception of the main family home.
- 1.2 The purpose of the bright-line test is to supplement the “intention test” in the current land sale rules. The intention test makes gains from the sale of real property purchased with an intention of resale taxable.
- 1.3 The intention test can be difficult to enforce due to its subjectivity. The bright-line test is intended to deal with the problem by supplementing the intention test with an unambiguous objective test.
- 1.4 The objective nature of the test means the bright-line test will make a sale of residential property taxable when the seller did not acquire the property with an intention of resale and when a person needs to sell property due to circumstances outside of their control. This is unavoidable for the bright-line test to achieve its goal of being objective and unambiguous.
- 1.5 For the bright-line test to be effective, the number of exceptions should be as few as possible, and tightly defined. However, we consider that some exceptions can be justified for types of acquisitions when the property is the main home of the seller or, in certain circumstances, when the seller did not intend to acquire the property.
- 1.6 This issues paper discusses the design of the bright-line test, where we have attempted to use existing rules in tax law where possible. This helps provide certainty for taxpayers, by using existing interpretations and guidance when applying the rules. Suggested wording for the charging provision and main home exception is provided in the Appendix. Officials are interested in feedback on the suggested changes outlined in this paper.

How to make a submission

- 1.7 Officials invite submissions on the suggested changes and points raised in this issues paper. Submissions should be addressed to:

Bright-line test for sales of residential property
C/- Deputy Commissioner, Policy and Strategy
Inland Revenue Department
PO Box 2198
Wellington 6140

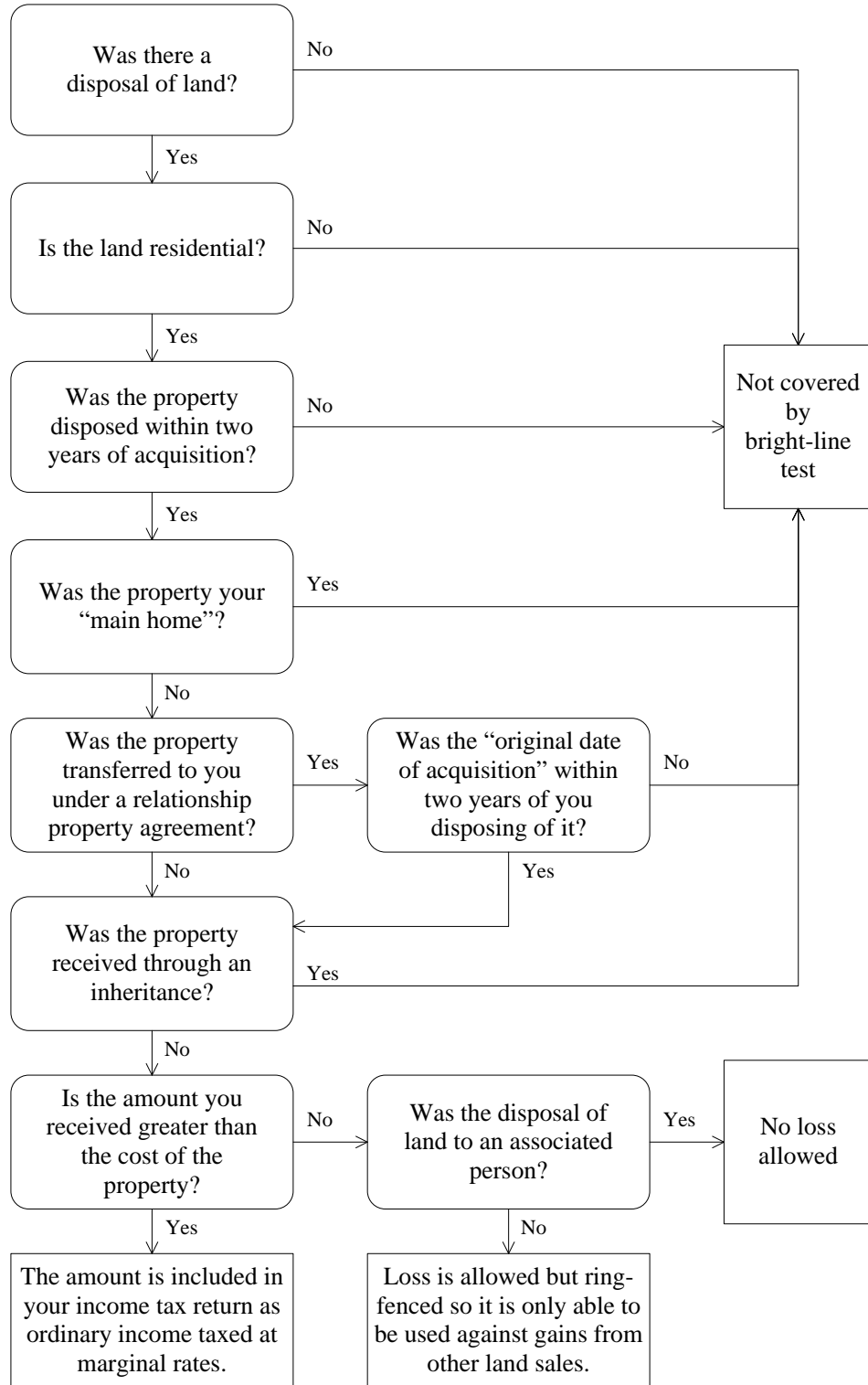
Or email policy.webmaster@ird.govt.nz with “Bright-line test for sales of residential property” in the subject line. Electronic submissions are encouraged. The closing date for submissions is 24 July 2015.

- 1.8 Submissions should include a brief summary of major points and recommendations. They should also indicate whether it would be acceptable for Inland Revenue and Treasury officials to contact those making the submission to discuss the points raised, if required.
- 1.9 Submissions may be the subject of a request under the Official Information Act 1982, which may result in their release. The withholding of particular submissions, or parts thereof, on the grounds of privacy, or commercial sensitivity, or for any other reason, will be determined in accordance with that Act. Those making a submission who consider that there is any part of it that should properly be withheld under the Act should clearly indicate this.

CHAPTER 2

Summary of suggested changes

2.1 Below is a summary of officials' suggestions for the design of the bright-line test.



Acquisition date and disposal

- 2.2 The two-year period for the bright-line test runs from the date of acquisition to the date of disposal. The date of acquisition is the date that title is registered for the purchase of the property and the date of disposal is the date that a person enters into an agreement for sale and purchase for the sale. When the disposal is other than by sale (for example, a gift), the date of disposal will be determined under the ordinary rules.
- 2.3 If disposal occurs before registration¹ (sales of the right to buy), the bright-line period runs from the day that a person enters into an agreement for sale and purchase (for the purchase of the right) to the date that a person enters into an agreement for sale and purchase (for the sale of the right).
- 2.4 The suggested bright-line test will apply to properties for which an agreement for sale and purchase is entered into from 1 October 2015, and which is subsequently disposed of. When the property was acquired other than by way of sale, the suggested bright-line test will apply to properties for which registration of title occurs after 1 October 2015.

Definition of “residential land”

- 2.5 Under the suggested changes, residential land means:
- 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.
- 2.6 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.

Main home exception

- 2.7 Under the suggested changes, the main home exception will apply when the land has a dwelling on it and the dwelling is occupied mainly as a residence and is the main home of:
- the owner; or
 - if the owner is a trustee, one or more beneficiaries of the trust.
- 2.8 If a settlor of a trust has a main home that is not owned by the trust, the main home exception cannot apply to any property owned by the trust.

¹ Including what are commonly referred to as sales “off the plan”.

Exceptions for relationship property and inherited property under the suggested changes

- 2.9 Under the suggested changes, inherited property is excluded from the bright-line test. This means no tax liability under the bright-line test would arise for the transfer of property under an inheritance, and the beneficiary would not be liable under the bright-line test for any subsequent disposal of the property.
- 2.10 Transfers of property under a relationship property agreement would not be subject to a tax liability under the bright-line test. However, any subsequent sale of the transferred property may be subject to the bright-line test. A liability would arise if the property is disposed of within two years of the registration date on the acquisition by the transferor (and the property was not the transferee's main home).

Deductibility of expenditure

- 2.11 Taxpayers would be allowed deductions for property subject to the bright-line test according to ordinary tax rules.

Losses

- 2.12 Losses arising only as a result of the bright-line test would be ring-fenced so that they may only be used to offset taxable gains arising under the land sale rules. As is currently the case, losses would not be ring-fenced if they are taxable under another land sale rule.
- 2.13 A person would not be able to recognise a loss under the bright-line test arising from a transfer of property to an associated person.

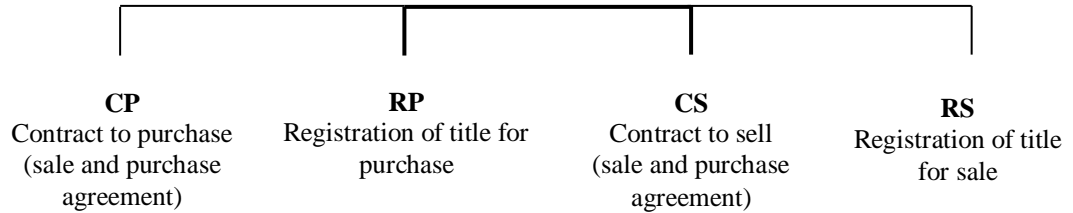
Land-rich companies and trusts

- 2.14 The use of land-rich companies and trusts to circumvent the bright-line test would be addressed through an anti-avoidance rule that deems a disposal subject to the bright-line test to have occurred if any of the following are done with the purpose or effect of defeating the intent and application of the suggested bright-line test:
- the disposal of shares;
 - a change in the trustees of a trust;
 - a change in the beneficiaries of a trust;
 - a change in the identity of any person who is able to appoint the trustee or the beneficiaries of a trust; and
 - a change in the ownership of a corporate trustee.

CHAPTER 3

Date of acquisition and disposal

- 3.1 Under the suggested changes, the bright-line test would apply to sales of property when the property is acquired and disposed of within two years. For most sales of residential property there are four relevant dates for acquisition and disposal.



- 3.2 There are two key objectives for defining the date of acquisition and disposal:
- providing a certain date so that sellers and Inland Revenue know if the sale falls within the bright-line test; and
 - minimising opportunities for people to avoid the bright-line test by artificially deferring sales.

Date of acquisition

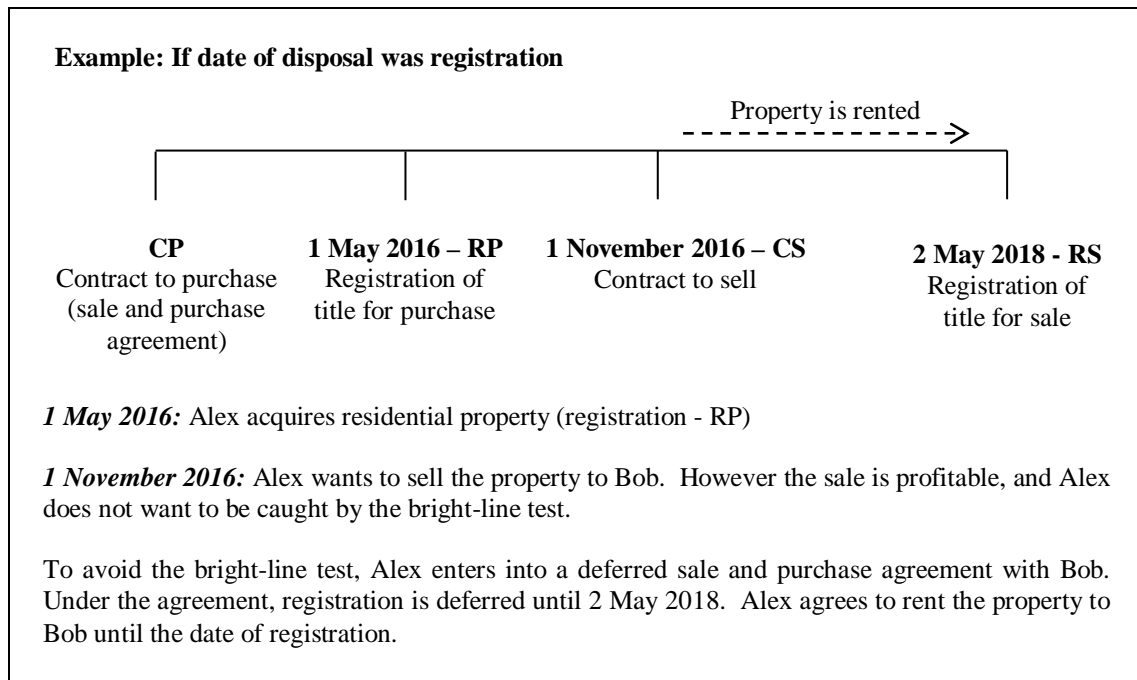
- 3.3 Under the current land sale rules the acquisition date is the date that a person enters into a sale and purchase agreement (CP). Using this date for the bright-line test is problematic. Where a seller has a different lawyer or conveyancer for the sale than they had for the purchase, the seller may not have access to the original sale and purchase agreement. This can mean it is difficult for the seller to know the original date they entered into a sale and purchase agreement, and for Inland Revenue to verify that date. This means that using the contract to purchase date as the date of acquisition would create uncertainty.
- 3.4 For the bright-line test, we think that the date of acquisition should be the date that title is registered for the purchase (RP). This provides a definite date recorded on Landonline² that can be easily used by sellers and Inland Revenue to know when the bright-line period starts.³

² <http://www.linz.govt.nz/land/landonline>

³ A definite date would also assist implementing a withholding tax. With a definite date it is easier for purchasers of property to know whether they need to withhold because the sale is subject to the bright-line.

Date of disposal

- 3.5 We think the date of disposal should be the date that a person enters into a contract to sell the property. This date is available to the seller at the time of the sale so provides certainty.
- 3.6 This would mean that the relevant date is different for acquisition and disposal. We think this is necessary, as using the date of registration for disposal leaves open an opportunity to avoid the bright-line test by artificially deferring a sale.



- 3.7 As the example above shows, the registration date could be deferred while still having the same economic outcome as a sale. This would provide a significant avoidance risk. As a result, we consider the date for disposal should be the date a person enters into a contract to sell the property.

Disposals with no contract to buy

- 3.8 Under the suggested changes, where a disposal does not involve a contract to sell (for example, a gift), the date of disposal will be determined according to ordinary rules.

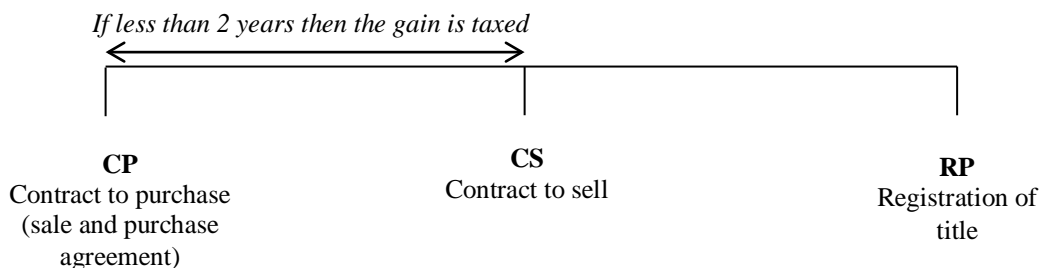
Subdivision of an existing title

- 3.9 For the purposes of the bright-line test, the date of acquisition for subdivided land by an owner is the original date of acquisition of the undivided land by the owner. An example is a person who acquires residential land in February 2016, subdivides the land in 2022, and sells the back section in 2023. The sale of the back section will not be subject to the bright-line test. The treatment is appropriate because the sale of the existing title would not be subject to the bright-line test because it would have occurred more than two

years after the land was acquired. However, if the back section had been subdivided and sold in 2017, the sale would be caught by the bright-line test.

Sales of the right to sell

- 3.10 An additional rule is needed for sales of the right to buy property (including sales “off the plan”).
- 3.11 A sale of the right to buy property is when a person sells their interest in property before the date of registration. When a sale of the right to buy property occurs within two years of acquiring that right, it is intended that the bright-line test should apply.
- 3.12 To capture these sales, we suggest that the bright-line test applies when a person:
- disposes of residential property before taking legal ownership (RP); and
 - the disposal was within two years of the seller entering into a sale and purchase agreement (CP).



Transitional rules

- 3.13 The bright-line test would apply to properties for which an agreement for sale and purchase is entered into from 1 October 2015, and which are subsequently disposed of. When the property was acquired other than by way of sale, the bright-line test would apply to properties for which registration of title occurs after 1 October 2015.

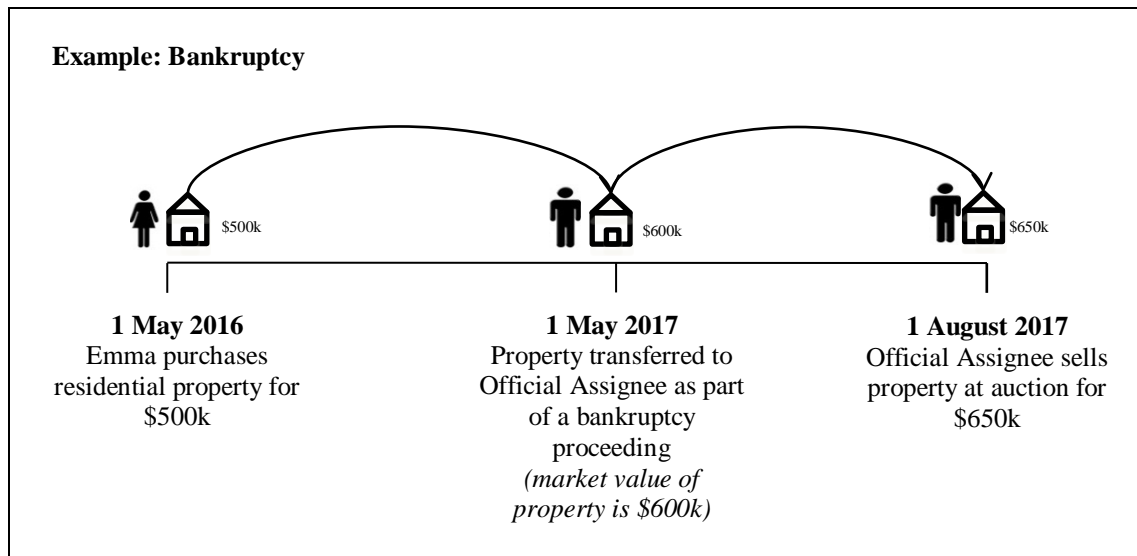
Example: Contract to buy before 1 October 2015

2 June 2015 – CP
Contract to purchase
(sale and purchase agreement)
1 November 2015 – RP
Registration of title for purchase
1 December 2015 – CS
Contract to sell

This transaction would not be covered by the bright-line test as the relevant sale and purchase agreement was entered into before 1 October 2015.

Disposals under insolvency

- 3.14 Disposals also occur as a result of individual or corporate insolvency. Officials welcome submissions on how the bright-line should apply to disposals in these situations.



CHAPTER 4

Definition of “residential land”

- 4.1 The bright-line test would only apply to residential land. This is because residential land has been identified as an area where there is particular difficulty in enforcing the land sale rules due to the high churn of such property and high volume of transactions.
- 4.2 Restricting the bright-line test to residential land does raise boundary issues, particularly for mixed-use land and bare land. The goal of the definition of “residential land” is to appropriately define this boundary and ensure that residential property and property developments are covered while, at the same time, not overreaching and inadvertently capturing commercial, industrial or agricultural property.

Suggested change

- 4.3 To appropriately balance these factors, we suggest 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.
- 4.4 The second criterion of this definition is intended to capture sales where the land is bare or currently being used for commercial or other purposes but is proposed to be developed into residential properties. This will ensure sales “off the plan” and other similar developments are captured.
- 4.5 This definition of residential land covers all land with a house on it but carves out those which are predominantly used for business purposes. The definition of “dwelling” would be the same as that currently used in the Income Tax Act 2007 but with adjustments to ensure that investors in serviced apartments are subject to the bright-line. However, a person who owns and operates serviced apartments as a business will not be subject to the bright-line due to the business premises exception.

Business premises and farmland definition

- 4.6 The current land sale rules have definitions of business premises and farmland that, with modification, we think are appropriate for use for the bright-line test.⁴
- 4.7 The suggested definition of “business premises” is land that is the premises of a business.

⁴ Sections CB 19 and CB 21 of the Income Tax Act 2007.

- 4.8 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.⁵

Definition of “land”

- 4.9 The definition of “land” under current tax law is:

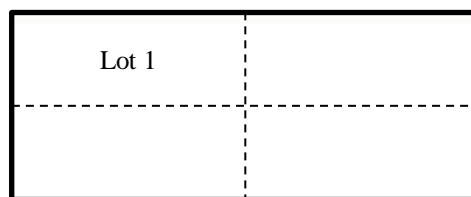
land —

- (a) includes any estate or interest in land:
- (b) includes an option to acquire land or an estate or interest in land:
- (c) does not include a mortgage

- 4.10 This means “land” for the bright-line will include freehold and leasehold estates in land.

- 4.11 There is some uncertainty in the current definition of “land” as to whether it includes an interest in land.⁶ We suggest clarifying that “land” does include an interest in land.

Example scenario: 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 Cara.

Lot 1 would be residential land and Bob would be subject to the bright-line test as Lot 1 is proposed to be used for residential purposes.

⁵ Capable of being worked as an economic unit as a farming or agricultural business means land capable of producing revenue sufficient to cover all costs of holding and operating the land, including the cost of capital employed and a reasonable recompense for the proprietor’s labour.

⁶ The current uncertainty is a result of an unintended legislative change during the Income Tax Act rewrite.

CHAPTER 5

Main home exception

- 5.1 The suggested bright-line test is intended to apply to most disposals of residential land within two years of the acquisition of the property. However, there are three situations when the disposal of property is not intended to give rise to a tax liability under the suggested bright-line test for any gains from a disposal.
- 5.2 The first situation is when the property is the main home of the vendor. Excluding a person's main home from the bright-line test is consistent with the current land sale rules, which generally exclude the sale of a person's principal residence.
- 5.3 The main home exception should be tightly defined. Where a property is used mainly for investment purposes or where a person has multiple homes the main home exception should not apply (or should not apply more than once).

Suggested change

- 5.4 We suggest that the main home exception applies when:
- the land has a dwelling on it;
 - the dwelling is occupied mainly as a residence by the owner; and
 - the dwelling is the main home of the owner.
- 5.5 If the property is owned by a trust, we suggest that the main home exception apply when the dwelling is occupied mainly as a residence by a beneficiary of the trust, and is the main home of a beneficiary of the trust.
- 5.6 If the settlor of the trust has a main home that is not owned by the trust, then we propose the main home exception cannot apply to any property owned by the trust.

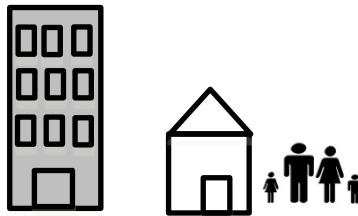
Mainly as a residence

- 5.7 We suggest that the main home exception apply when the dwelling is occupied mainly as a residence. This requirement is the key test for the residential exclusion within the current land sale rules and is intended to ensure that properties used mainly for investment or other purposes are not covered by the exception.
- 5.8 It is intended that this test is determined based on what a person's actual use of the property is rather than what they intended the property to be used for.

Main home

- 5.9 A person should only be able to use the main home exception for one property at a time. To enable this, we suggest the exception applies to a property that is the “main home” of the owner and is used “mainly as a residence” by the owner.
- 5.10 Where a person has several residences, their “main home” is determined according to which property a person has the greatest connection. The factors that determine these connections would be similar to those used to determine whether a dwelling is a person’s “permanent place of abode” for residence rules and include:
- the time the person occupies the dwelling;
 - where their immediate family (if any) live;
 - where their social ties are strongest;
 - the person’s use of the dwelling;
 - the person’s employment, business interests and economic ties to the area where the dwelling is located; and
 - whether the person’s personal property is in the dwelling.

Example: Multiple homes



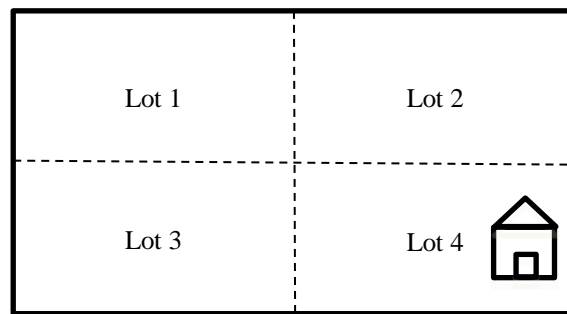
Bob has two homes.

One home is a small apartment in Christchurch, which Bob lives in five days a week because he works in Christchurch.

The other home is in Wellington where his family lives. Bob lives in his Wellington home during weekends and holidays. His Wellington home is also where most of his personal possessions are located.

The Wellington home is Bob’s main home as it is the place he has the greatest connection with.

Example: Subdivision



1 May 2016: Andrew buys a large plot of land which has a house on it. Andrew lives in the house.

1 June 2017: Andrew subdivides the land into four lots. Lot 4 contains the house Andrew lives in.

1 July 2017: Andrew sells Lot 1.

Andrew cannot use the main home exception for Lot 1 because it does not have a dwelling on it.

Trusts

5.11 A significant number of family homes in New Zealand are owned by family trusts. Accordingly, the main home exception has been drafted to allow for this possibility, so that a home owned by a trust can be regarded as a main home. However, when a person's family members live in different dwellings, there is a risk of trust ownership being used to claim the main home exception for more than one residence.

5.12 To prevent the inappropriate use of the main home exception by trustees, we suggest that property owned by a trust is not eligible for the exception if a settlor of the trust:

- separately owns a main home; or
- is a beneficiary of another trust that owns the main home for the settlor.

Example: Student flat



Dave has two properties, a family home which he lives in, and a student flat which his son lives in while studying on a three-year course.

Dave puts the student flat into a trust and makes his son a discretionary beneficiary of the trust.

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

Regular pattern of acquiring and disposing

- 5.13 The current residential exclusion does not apply to a person who engages in a regular pattern of acquiring and disposing of dwellinghouses. This is intended to ensure habitual renovators cannot utilise the residential exclusion (those who repeatedly purchase property with an intention of resale, occupy the property, renovate it and then sell it).
- 5.14 For the purposes of the bright-line test we consider that this provision would be unnecessary as the “habitual renovator” would be captured by the intention test in the current land sale rules. It would also be overly harsh for a person who genuinely has to move homes multiple times due to circumstances outside of their control.

CHAPTER 6

Exceptions for inherited property and relationship property

- 6.1 In addition to the main home exception, we suggest two further situations when the disposal of residential land is not intended to give rise to a tax liability under the bright-line test. The two situations are when the property is transferred:
- on the death of a person; or
 - under a relationship property agreement.

Property transferred on the death of a person

- 6.2 When a person dies, their property may be sold or transferred to a beneficiary, who may subsequently sell the property. It is intended those disposals will not trigger a liability for tax under the bright-line test.

Transfer of property from deceased to beneficiaries

- 6.3 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).
- 6.4 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.
- 6.5 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.
- 6.6 Normally, it takes nine to twelve months to wind up an estate with real property and distribute the assets to 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 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.

Transfers of land subject to the current land rules

- 6.7 Tax law treats the distribution of property following the death of a person as two transfers. The first transfer is from the deceased person to the administrator or executor and is deemed to occur immediately before the person dies. The second transfer is from the executor or administrator to the beneficiary and occurs on the date of the relevant transaction. The current rules distinguish between:
- transfers to a surviving spouse, de facto partner or civil union partner (relationship partners), a close relative or a charity; and
 - other transfers.

6.8 These two situations are discussed below.

Certain transfers to a relationship partner, close relative or charity

- 6.9 The current rules provide special treatment (commonly referred to as “rollover relief”) for transfers to relationship partners, close relatives and charities (subject to certain conditions).
- 6.10 The effect of the rollover relief is not to tax the deceased person or their estate for any possible tax liability on the disposal of the property but to delay any tax liability until any subsequent disposal by the beneficiary.
- 6.11 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 current land rules arise under the transfers. When a major development is being undertaken on the land, it is treated as being disposed of for, and acquired at, the market value of the land at the commencement of the undertaking or scheme plus any expenditure that has been incurred on the development. This has the effect of transferring the land at its tax book value so no income tax liability is triggered on the transfer. Further, if a person holds land which would be taxable if sold within 10 years of acquisition, the person’s death will not trigger a tax liability.
- 6.12 Instead, the relevant time periods under the current land rules and the intentions of the deceased person are inherited by the beneficiary. This means that if the beneficiary subsequently disposes of the property, they will be subject to any of the applicable current land rules and so may be subject to income tax on any gains they derive from the sale.
- 6.13 Not all transfers to relationship partners, close relatives or charities are accorded rollover relief. The current rules provide certain conditions that must be satisfied for the rollover relief to apply.

Other transfers

6.14 Rollover relief is not accorded if the transfer is:

- to a person other than a relationship partner, close relative or charity; or
- to a relationship partner, close relative or charity but the relevant conditions for rollover relief are not satisfied.

6.15 In those situations, the property is deemed to be:

- transferred from the deceased person to the executor or administrator at market value, which may trigger a tax liability if the market value is greater than the cost of the property;
- transferred from the executor or administrator to the beneficiary at market value, which may trigger a tax liability; and
- acquired by the beneficiary on the date of the transfer to the beneficiary. The beneficiary may in their own right be subject to one of the current land rules on the disposal of property. For example, a relevant zoning change may occur after they acquire the property or they may be subject to one of the 10-year rules. If that is the case, the disposal by the beneficiary may also be subject to tax.

Options

6.16 Various options have been considered about how the proposed bright-line test would apply to land that was transferred following a person's death. Specifically, consideration has been given to:

- applying the current rollover relief provisions to land subject to the proposed bright-line test;
- applying the current rollover relief provisions but also allowing an exemption for any subsequent disposal of the land by the beneficiary; or
- extending the current rollover relief to all transfers following the death of a person and providing an exemption for any subsequent disposal by the beneficiary.

6.17 We recommend the third option. All the options are discussed below.

Applying the current rollover relief

6.18 Applying the current rollover relief provisions to land subject to the bright-line test would extend the concessionary treatment only to land transferred to relationship partners, close relatives and charities (in certain circumstances). In such circumstances, the transfers to the executor or administrator, and from the executor or administrator to the beneficiary, would not generate a tax liability. However, any subsequent disposal by a relationship partner or close relative could be subject to the bright-line test if the property was sold within two years from the registration date of the acquisition by the deceased person.

- 6.19 A transfer to someone other than a relationship partner, close relative or charity (or a transfer that does not satisfy the relevant conditions) would not be accorded rollover relief. Instead, the death of a person within two years from the registration date of acquisition of residential property would trigger the bright-line test (subject to the exception for the main home). Likewise, the subsequent transfer from the executor or administrator to the beneficiary might also trigger the bright-line test if it occurred within two years. Further, any subsequent disposal of the property by the beneficiary within two years from the date of transfer might trigger the bright-line test.

Applying the current rollover relief and an exemption

- 6.20 Consideration has also been given to applying the current rollover relief provisions but also providing an exemption for any subsequent disposal by the beneficiary. The basis for this approach would be that the beneficiary had not intended to acquire the property, and so should not be deemed to hold the property on revenue account just because the deceased person had held the property on that basis. This would be in contrast to the current land rules, which do deem a beneficiary to hold the property on revenue account if the deceased person held it on revenue account. Applying an exemption for the bright-line test would, therefore, be more concessionary than the current land rules. However such an approach would only apply to relationship partners and close relatives.

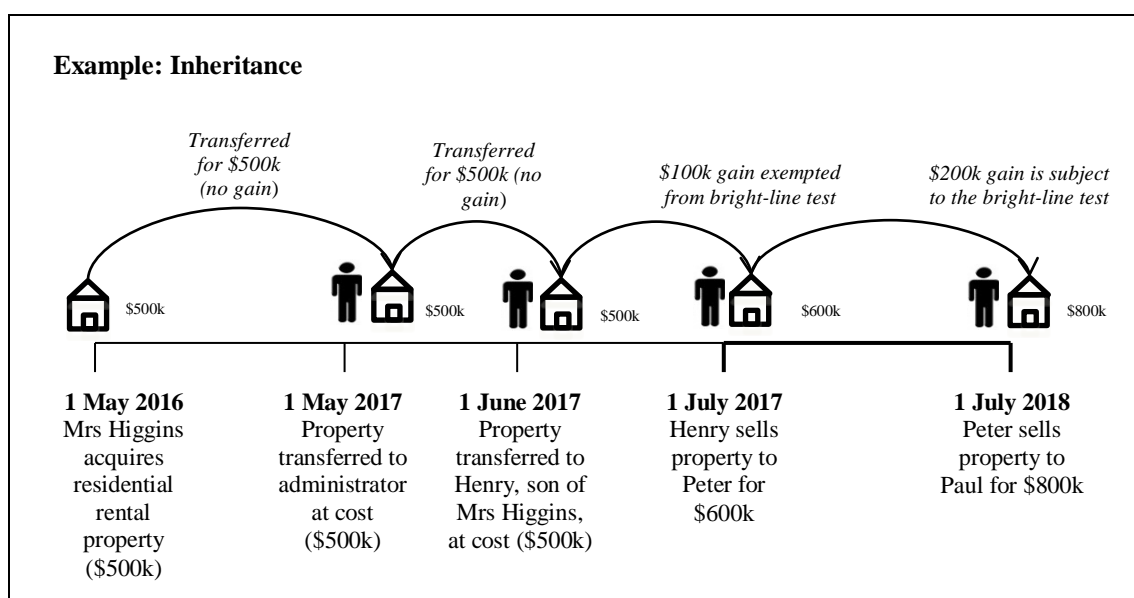
Extending the current rollover relief to all transfers following a death and an exemption

- 6.21 The preferred approach for the bright-line test is to extend the current rollover relief to all transfers following a death and to provide an exemption under the bright-line test for any disposals by the executor or administrator and subsequent disposals by the beneficiaries.
- 6.22 The basis for extending the rollover relief is that because the bright-line test applies more broadly than the current land rules, it is appropriate to provide a broader exception for transfers following the death of a person. In that sense, it is considered appropriate the rollover relief applies no matter what the relationship is between the deceased person and the beneficiary. In other words, the relationship of the beneficiary to the deceased person should not determine the tax treatment of the transfer under the bright-line test following a death.
- 6.23 The basis for allowing an exemption from the bright-line test for a sale by the executor or administrator, or any subsequent sale by the beneficiary, is the same as described above. Specifically, the basis for the approach is that the beneficiary has not intended to acquire the property, and so should not be subject to the bright-line rule, which is intended as a buttress to the intention of resale rule.

6.24 The proposed exception for the bright-line test would not prevent the current land sale rules applying to any subsequent sale of the property by the beneficiary (if it would have been taxable had the deceased person sold it). The exception will have the effect of not bringing into the tax base any sales of inherited property that would not have been brought into the tax base under the current rules.

Summary

6.25 The bright-line test is intended to apply to most disposals of residential land within two years of the acquisition of the property. However, there is an exception for land transferred as a result of a death. The current rules provide rollover relief for transfers following a death to relationship partners, close relatives or charities but not other transfers. The preferred approach for the bright-line test is to extend the current rollover relief to all transfers following a death and to provide an exemption for any disposals by the executor, administrator or beneficiaries.



Property transferred under a relationship property agreement

6.26 When a relationship breaks down, property may be transferred between the spouses or partners. The property may then subsequently be sold. It is intended that the transfers of property under a relationship property agreement will not be subject to a tax liability under the bright-line test. However, any subsequent sale of the transferred property may be subject to the bright-line test.

Transfer of property under a relationship property agreement

6.27 During a marriage, civil union or de facto relationship, the parties hold any property according to the conventional laws relating to property. As a result, the parties are free to deal with their property during the relationship without regard to the provisions of the Property (Relationships) Act 1976.

- 6.28 When a relationship breaks down, the Property (Relationships) Act 1976 may be invoked by a court order or an agreement between the parties. When the statutory regime is invoked, new property rights operate from the date of the court order or agreement. The property of the spouses or partners is reapportioned between them under principles derived from the statutory regime. Each item of property is divided into one of two statutory categories:
- relationship property; and
 - separate property.
- 6.29 The fact that a particular item of property is placed within one of these two categories then produces a *prima facie* result in the way it is treated as between the two spouses or partners. *Prima facie* all relationship property is divided in equal shares, while separate property is retained by the owner.
- 6.30 Spouses or partners can enter into an agreement under the Property (Relationships) Act 1976 in an on-going relationship (often referred to as a section 21 agreement). Such agreements cannot transfer ownership of property but may only affect the “status” of property (that is, whether it is “separate property” or “relationship property”).

Transfers of land subject to the current land rules

- 6.31 Land that is subject to the current land rules that is transferred under a relationship property agreement is eligible for rollover relief that is similar to that described above. In other words, for such land the transfer is treated as a disposal and acquisition for an amount that equals the total cost of the land to the transferor. When a major development is being undertaken on the land then it is treated as being disposed of for, and acquired at, the market value of the land at the commencement of the undertaking or scheme plus any expenditure that has been incurred on the development. The effect of this is that no tax liabilities under the current land rules arise under the transfers.
- 6.32 A subsequent disposal of the land by the transferee will be taxable under the current land rules if:
- the property is sold for more than the cost of the land to the transferee; and
 - the amount would have been income of the transferor under the current land rules if they had disposed of the land.

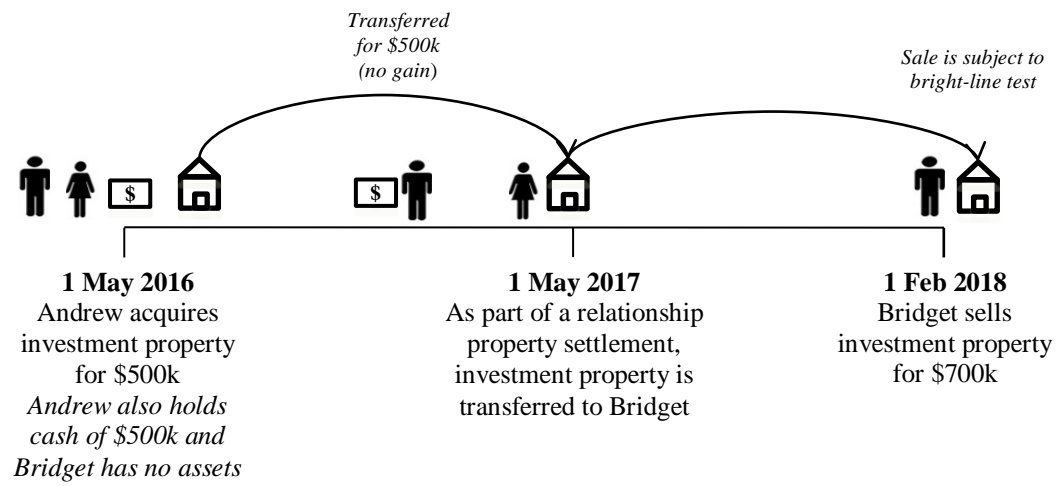
Preferred option

- 6.33 The preferred option is to retain the current rollover relief for transfers under a relationship property agreement for the bright-line test. This will mean that no tax liability under the bright-line test arises for the transfer of the property under the relationship property agreement. However, the transferee may be liable under the bright-line test for any subsequent disposal of the property. A liability will arise if the property is disposed of within two years of the registration date on the acquisition by the transferor (and the property was not the transferee's main home).

Why adopt a different approach to transfers on the death of a person to a transfer under a relationship property agreement?

- 6.34 As discussed above, the preferred approach for the bright-line test following the death of a person is to extend the current rollover relief to all transfers, and to provide an exemption for any subsequent disposals by the beneficiaries. In contrast, the preferred approach for the bright-line test for a transfer under a relationship property agreement, is to retain the current rollover relief and not provide an exemption for any subsequent disposal by the transferee.
- 6.35 Accordingly, the preferred approaches under the bright-line test differ for property transferred following a death to that under a relationship property agreement. It is acknowledged it could be argued that the same approach should be adopted to both types of transfers. It is considered, however, that there is a principled basis for distinguishing between the two circumstances, and providing for different treatments. Specifically:
- In most cases, for the property to be transferred as relationship property under a relationship property agreement the relationship will have had to be in existence for at least two years'. This means that for the most part, property that is subject to the bright-line test would have been acquired during the relevant relationship. It can, therefore, be presumed that both parties to the relationship had a joint purpose or intention in relation to the property when it was acquired. In those circumstances, it is more appropriate to apply the bright-line test to either party following the end of the relationship.
 - A transferee following a death does not have any choice about what property is transferred to them. They can refuse the legacy or gift but they cannot choose to receive different property. The transferee, therefore, may become a reluctant landlord or property investor following a legacy or gift and it seems appropriate to allow them to dispose of the property in those circumstances without being liable to tax. In contrast, there is more opportunity to negotiate the property that a transferee receives under a relationship property agreement. In those circumstances, it seems more appropriate to apply the current rollover relief but have no exemption for any subsequent sale.

Example: Relationship property settlement



CHAPTER 7

Deductions

- 7.1 For property that is liable for tax under the bright-line test, taxpayers will be able to deduct expenditure according to the ordinary rules.

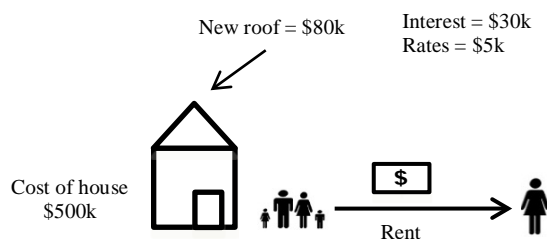
The cost of the property can be deducted

- 7.2 A person who sells property that is subject to the bright-line test will be allowed a deduction for the cost of the property at the time of sale.
- 7.3 The cost of the property includes the amount that was paid to acquire the property (the initial acquisition price of the property). The cost of the property also includes any expenditure related to the acquisition. As a result, the costs of lawyers, valuers, surveyors and real estate agents are deductible. The incidental costs of disposing of the property are also deductible as part of the cost of the property. The cost of the property also includes any capital improvements to the property made after acquisition, such as renovations.

Holding costs deductible to the extent sufficient nexus and not private in nature

- 7.4 While a property is owned there will be periodic holding costs (of a non-capital nature) such as interest, insurance, rates and repairs and maintenance expenses.
- 7.5 The deductibility of holding costs that are currently deductible will not be affected by the bright-line test. Further, holding costs that are currently not deductible will not become deductible because of the bright-line test.
- 7.6 To be deductible as incurred, the holding costs must satisfy the normal deduction requirements. In other words, the holding costs are deductible to the extent they have a nexus with income and are not private in nature (or otherwise subject to any of the general limitations on deductions).
- 7.7 A deduction will be of a private nature if it is exclusively referable to living as an individual member of society. This will be determined by the specific facts of any given situation. However, interest costs can automatically be deducted if the property is owned by a company (subject to some limitations).
- 7.8 For example, when the property is part of a business or profit-making undertaking or scheme, and there is no private use, it is likely that the nexus will be satisfied. Further, when the property is rented out there will likely be a nexus between the holding costs and the rental income. However, if a person purchases a bach for family use, but sells the bach within two years, the holding costs will not be deductible because of the private limitation.

Example: Rental property



May 2016: Carla buys a 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

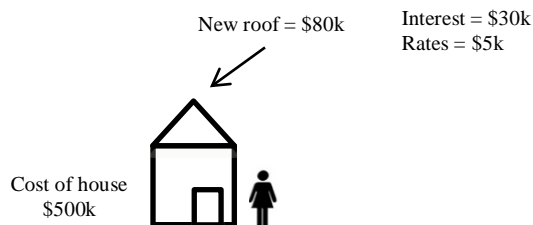
2 April 2017: Carla sells the property for \$800k

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

Example: Beach house



May 2016: Denise buys a 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 – The interest and rates are subject to the private limitation

Deductions in 2017–18 year = \$580k (Cost base of property = house and roof)

Income in 2017–18 year = \$800k

CHAPTER 8

Treatment of losses

- 8.1 The current land sale rules allow the cost of property disposed of in a taxable sale to be deducted without limitation. It is not relevant that it may exceed the proceeds of disposal.
- 8.2 *Prima facie* this is the correct outcome. Enabling losses to be claimed in circumstances when gains are taxable ensures symmetry and avoids economic distortions. If losses are not able to be claimed it would mean that risky assets would be undervalued and this would result in investment decisions being affected by tax.
- 8.3 However, an unrestricted ability to use losses from the bright-line test raises risks:
- It creates an incentive for taxpayers with unrealised losses before the two-year date to accelerate sales to fall within the two-year bright-line period, and an incentive for taxpayers with unrealised gains at that time to defer the sale of property after two years.
 - This raises revenue risks as taxpayers are given the opportunity to maximise claimable losses and minimise taxable gains. This is especially the case as a taxpayer who falls within the bright-line test may be able to deduct otherwise non-deductible expenses.

Ring-fencing losses

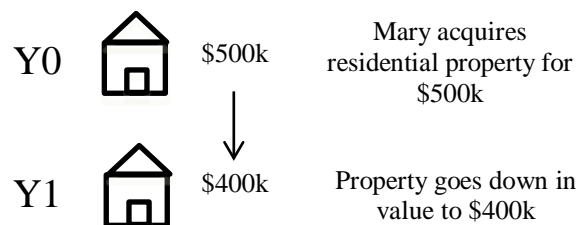
- 8.4 To minimise these risks, we suggest ring-fencing losses claimable due to the bright-line test, so they are only able to be offset against taxable gains on other land sales.
- 8.5 This proposed ring-fencing would apply where the sale is taxable solely because it is covered by the bright-line test. The ring-fencing would not apply if the sale is taxable under any of the other land sale rules.
- 8.6 Ring-fencing losses reduces the revenue risk referred to above, as taxpayers have less incentive to accelerate sales if they do not have offsettable gains and less incentive to defer sales if they have ring-fenced losses.
- 8.7 Ring-fencing does create a risk of a new distortion as gains and losses are not taxed symmetrically. As a result, it may discourage economically efficient activity when a person does not have any offsettable gains. We think this risk is minor.

- 8.8 Ring-fencing will not affect persons who buy and sell on a frequent basis as they are allowed to claim losses normally under the other land sale rules. For those who are not selling on a frequent basis, denying losses is unlikely to impose a large cost as they perform a relatively small economic function in the housing market.

Losses from transfers to associated persons

- 8.9 When a property has declined in value it is possible for a person to transfer a property to an associated person in order to recognise the loss under the bright-line test without any real economic transaction occurring.

Example: Transfer to associated person



Mary wants to realise the loss in the property to reduce her tax liability on her other incomes but does not want to lose control over the property.

To achieve this Mary transfers the property to her partner Ned for \$400k.

- 8.10 To prevent this, we suggest that a person should not be able to recognise a loss under the bright-line test arising from a transfer of property to an associated person.

CHAPTER 9

Land-rich companies and trusts

- 9.1 The current land sale rules do not apply to the sale of shares in a land-rich company,⁷ or to the change in terms of a land-rich trust⁸ which effectively transfers the beneficial ownership of trust assets.
- 9.2 It is important that people cannot readily avoid the bright-line test through the use of trusts and companies. As a result, we think it is important to have a rule dealing with this issue. Two options for this are:
- a comprehensive set of rules that set out when a sale of shares in a land-rich company, or a change in the terms of a land-rich trust, should give rise to a taxable gain or loss; or
 - a specific anti-avoidance rule for land-rich companies and trusts.
- 9.3 The key trade-off between these two options is between accuracy and simplicity.
- 9.4 A comprehensive set of rules would potentially provide a robust regime covering all land-rich companies and trusts. This would ensure that the tax treatment for residential property is identical no matter what legal form the property is held in. However, such a set of rules would be complex and require detailed legislation.
- 9.5 A specific anti-avoidance rule would be simpler and avoid the associated risks of increased compliance costs. It would, however, be less robust.
- 9.6 On balance, we favour a specific anti-avoidance rule in relation to land-rich companies and trusts used to circumvent the bright-line test. At present it does not appear that there are large volumes of residential property being traded through sales of companies or amendments to the terms of trusts. As a result, we think that a comprehensive set of rules would create additional complexity to target a relatively small problem.
- 9.7 If, over time, the use of land-rich companies and trusts that circumvent the bright-line test become more common this may need to be revisited.

Design of anti-avoidance rules

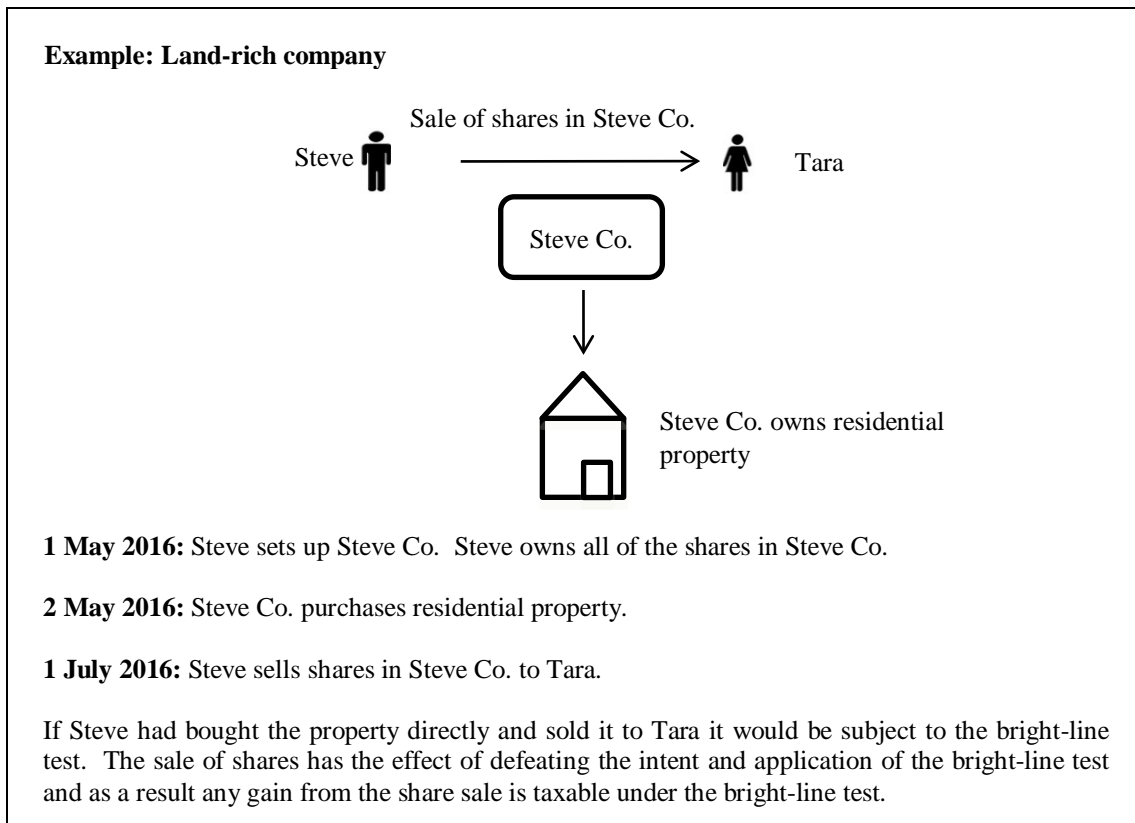
Companies

- 9.8 An anti-avoidance rule is suggested for the bright-line test that would deem a disposal of property held by a company to have occurred if there is a disposal of shares with the purpose or effect of defeating the intent and application of the bright-line test.

⁷ However, the sale of shares is taxable if acquired with the dominant purpose of resale.

⁸ “Change in terms” means any changes referred to in paragraph 9.10.

9.9 When this rule applies, the tax liability would be with the selling shareholder.



Trusts

9.10 An anti-avoidance rule is suggested for the bright-line that would deem a disposal of property held by a trust to have occurred if any of the following is done with the purpose or effect of defeating the intent and application of the bright-line test:

- a change in the trustees of a trust;
- a change in the beneficiaries of a trust;
- a change in the identity of any person who is able to appoint the trustee or the beneficiaries of a trust; or
- a change in the ownership of a corporate trustee.

9.11 When this rule applies, the income would arise either at the trust level (giving rise to liability to the trustee or settlor) or it could potentially be beneficiary income so that the relevant beneficiary would have a tax liability.

APPENDIX

Proposed wording for charging provision and main home exception

New section CB 6A (Disposal within 2 years: residential land)

CB 6A Disposal within 2 years: residential land

An amount that a person derives from disposing of residential land is income of the person, if the person enters into an agreement for the disposal of the residential land within 2 years of—

- (a) the date on which the instrument to transfer the land to the person was registered; or
- (b) the date on which the person entered into the agreement for their acquisition of the land, if there is no date under paragraph (a).

New section CB 6A (Main home exclusion for disposal within 2 years)

CB 16A Main home exclusion for disposal within 2 years

Section CB 6A does not apply to a person who disposes of residential land, if it has a dwelling on it that was the main home for—

- (a) the person; or
- (b) a beneficiary of a trust, and—
 - (i) the person is a trustee of the trust; and
 - (ii) the settlor of the trust does not own a main home; and
 - (iii) the settlor of the trust is not a beneficiary of another trust, the trustee of which owns the settlor's main home.

Definitions

dwelling, for the purposes of section CB 16A and the definition of **residential land**,—

- (a) means any place used predominantly as a place of residence or abode including any appurtenances belonging to or enjoyed with the place; but
- (b) does not include—
 - (i) a hospital;
 - (ii) a hotel, motel, inn, hostel, or boardinghouse;
 - (iii) a convalescent home, nursing home, or hospice;
 - (iv) a rest home or retirement village;
 - (v) a camping ground.

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

main home means, for a person, the 1 home—

- (a) that is mainly used as a residence by the person and any member of the person's family living with the person; and
- (b) with which the person has the greatest connection.

residential land,—

- (a) means—
 - (i) land that has a dwelling on it; or
 - (ii) land for which there is an arrangement that relates to erecting a dwelling; but
- (b) does not include land that is used predominantly as business premises or as farmland.