

# DETAIL OF BRIGHT-LINE TEST

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# What is the bright-line test?

*The bright-line 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.*

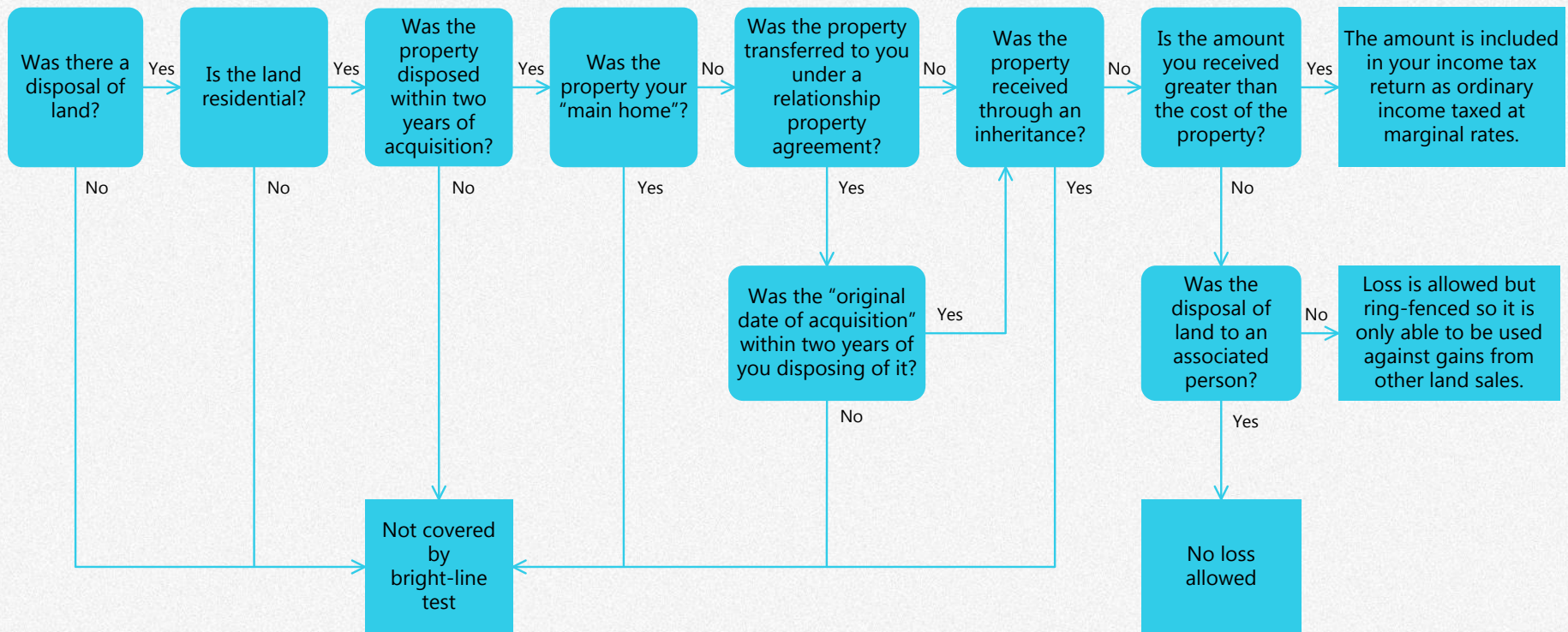
*The goal of the bright-line is to supplement the "intention" test in the current land sale rules*

The intention test is difficult to enforce due to its subjectivity. The bright-line is intended to supplement the intention test with an unambiguous objective test.

The objective nature of the test means the bright-line test will make a sale of residential property taxable in circumstances when the seller did not acquire the property with an intention of resale. However, this is unavoidable for the bright-line test to achieve its goal of being unambiguous and objective.

In the design of the bright-line test we have aimed to use existing rules in tax law where possible. This helps provide certainty as it enables taxpayers to use existing interpretations and guidance when applying the rules.

# When does the bright-line test apply?

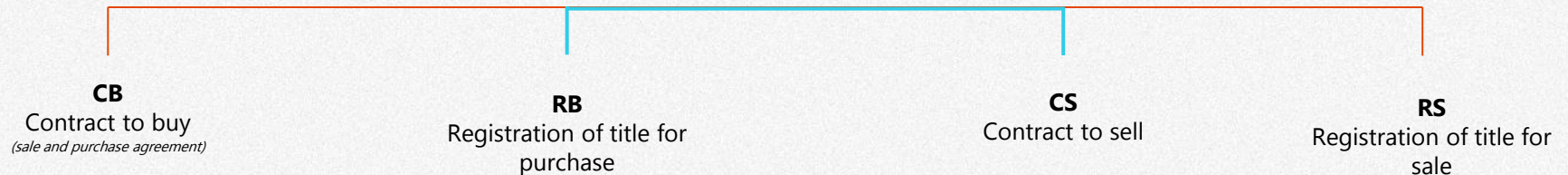




**Date of  
acquisition  
and disposal**

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# Date of acquisition and disposal



## *There are four relevant dates*

Under the current land sale rules the acquisition date is the date that you enter into a sale and purchase agreement (CB).

## *We think the date of acquisition should be the date of registration (RB)*

This provides a definite date recorded on Landonline that can be easily used by sellers, Inland Revenue, and buyers (for withholding tax purposes) to know when the bright-line period starts.

## *We think the date of disposal should be the date you enter into a contract to sell (CS)*

Using the registration date (RB) as the date of acquisition means that for consistency you would choose the date of registration (RS) as the date of disposal.

However, we think this leaves open an opportunity for avoidance that is too great and so would prefer CS.



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# Example scenario: deferring registration



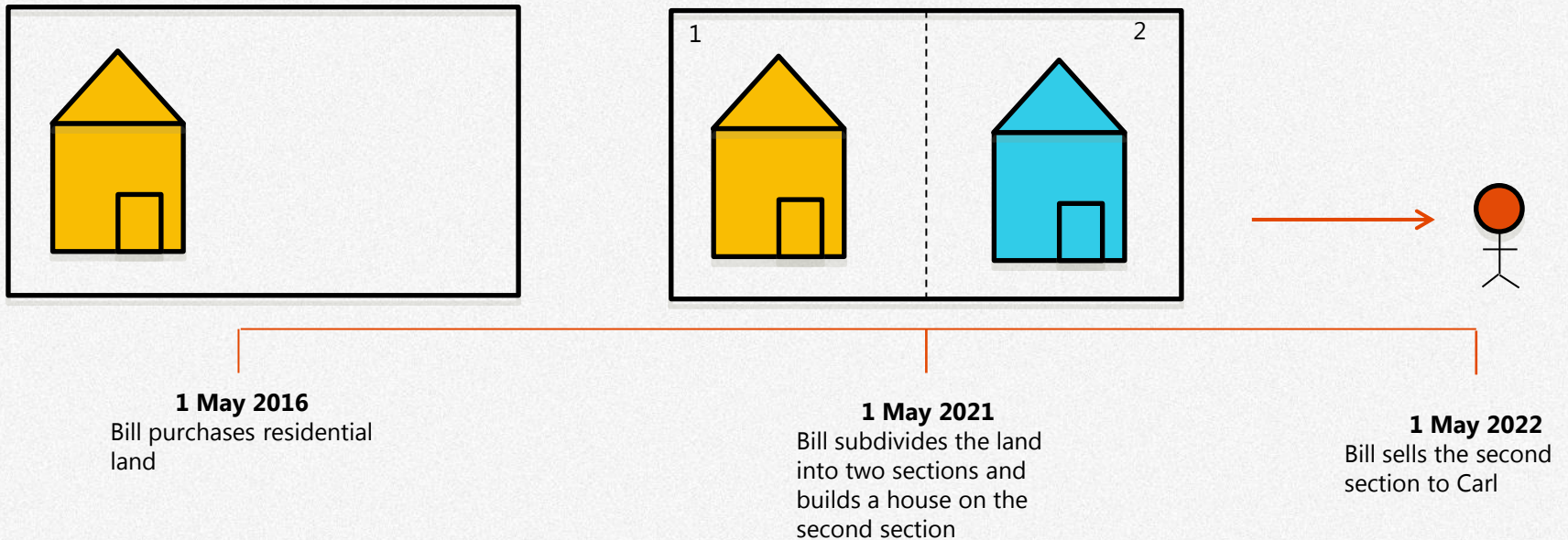
## *How to defer settlement*

1 May 2016: Alex acquires residential property (registration – RB)

1 November 2016: Alex wants to sell the property to Bob. However, Alex does not want to be caught by the bright-line.

To avoid the bright-line Alex enters into a deferred sale and purchase agreement with Bob. Under the agreement, registration of title is deferred until 2 May 2018. Alex agrees to rent the property to Bob until registration.

# Date of acquisition for subdivision



*The date of acquisition for subdivided land by an owner is the original date of acquisition of the undivided land by the owner.*

*In this situation, the sale of the second section by Bill is not subject to the bright-line test as it was disposed of more than two years after the original date of acquisition.*



# Sales of the right to buy



*An additional rule is needed for sales of the right to buy (sales "off the plan")*

This is where a person sells their interest in property prior to registration of the title.

We want to catch these sales and so propose that the bright-line applies where there is:

- A disposal of residential property where disposal (CS) occurs prior to registration of title (RB); and
- The disposal was within two years of the seller entering into a sale and purchase agreement (CB).

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# Transitional rules

**This sale not subject to bright-line as sale and purchase agreement entered into before 1 October 2015**

**2 June 2015 - CB**  
Contract to buy  
*(sale and purchase agreement)*

**1 November 2015 - RB**  
Registration of title for  
purchase

**CS**  
Contract to sell

**RS**  
Registration of title for  
sale

*The bright-line will apply to sales of property bought from 1 October 2015*

This could mean either property for which a sale and purchase agreement has been entered into from 1 October (CB) or property for which registration of title has been completed from 1 October (RB).

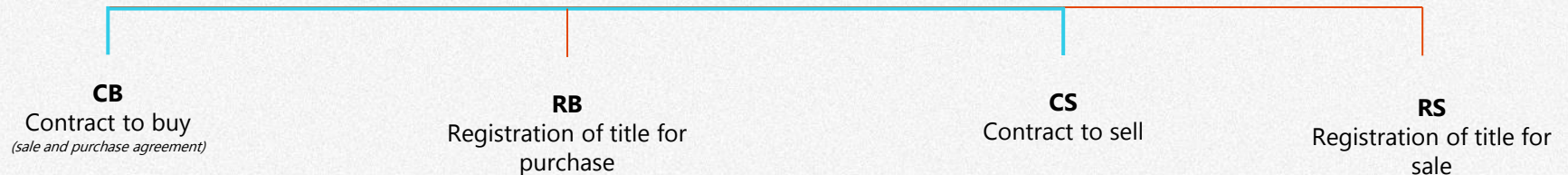
*We think the correct choice is property that a sale and purchase agreement (CB) is entered into from 1 October 2015*

This ensures the bright-line does not apply to existing transactions retrospectively.



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# Issues paper submissions on acquisition



*The majority of submissions opposed using RB as the start date for the bright-line period and supported using CB instead.*

Reasons for this included:

- Consistency with existing land-sale rules
- Reducing complexity
- Consistency between acquisition and disposal
- Submitters considered the CB date would be easily available to sellers
- Removes need for separate off-the plan rule

*We consider that RB is the most appropriate date*

The key requirement for the acquisition date is verifiability

Verifiability is needed to ensure that the bright-line is easy to enforce and is needed as a withholding tax would be difficult to implement without a clear date accessible to the purchaser.

Registration is the only date recorded on Landonline so to have a definite and recorded date, the date of acquisition needs to be RB.

# Definition of residential land



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# Definition of residential land

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## *The bright-line test will apply only 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 volume and churn of such property.*

This does raise boundary issues particularly for mixed-use land and bare land.

The goal of the definition of residential property is to adequately draw this boundary and ensure that commercial property is not inadvertently caught.

### *Residential land is:*

- *Land that has a dwelling on it; or*
- *Land for which the owner has an arrangement that relates to building a dwelling on it; or*
- *Bare land that because of its area and nature is capable of having a dwelling erected on it*

But does not include land that is used predominantly as business premises or as farmland

*This captures all land with a house on it but then carves out land used mainly for business purposes or as farmland.*

The requirement for land which there is an arrangement to build a dwelling and bare land capable of having a dwelling is intended to capture land where there is a plan to build a dwelling on it and bare land likely to have a dwelling.

### *Farmland:*

- *The area and nature of the land disposed of mean it is then capable of being worked as an economic unit as a farming or agricultural business*

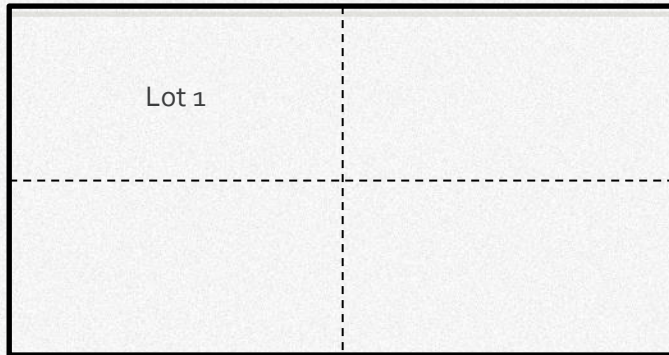
### *Arrangement*

- *An agreement, contract, plan, or understanding*



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# Example scenarios

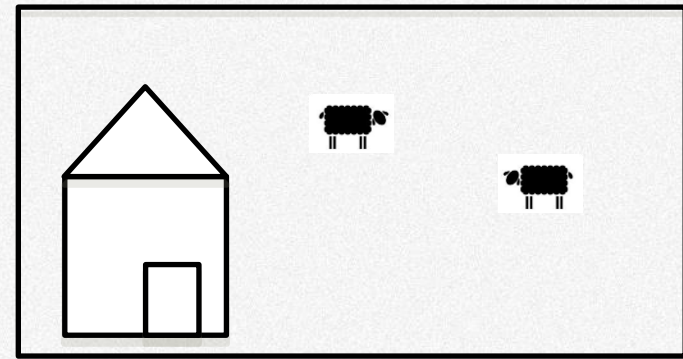


## *Development*

Andrew buys an empty plot of land. He plans to develop the plot by subdividing it into 4 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 as there is an arrangement to build a dwelling on it and because it is bare land that due to its area and nature is capable of having a dwelling on it.



## *Lifestyle block*

Lifestyle block with house and small area of farmland. Land is used for grazing a small number of sheep.

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

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



**Main home  
exception**

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# Current rules

## *Main home exception*

The bright-line is not intended to apply to the sale of a person's main home.

Excluding a person's main home is consistent with the current land sale rules, which generally exclude the sale of a person's principal residence.

## *Defining main home*

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).

## *Proposal*

We propose that the main home exception apply where the land has been used predominantly, for most of the time the person owns the land, as the person's main home.

Main home means the one dwelling:

- *That is mainly used as a residence by the person; and*
- *With which the person has the greatest connection*



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# Detail of main home exception

## *Mainly as a residence*

The main home exception will apply only where the dwelling is occupied mainly as a residence by the owner. 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.

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 when they bought it.

## *Trusts*

If the property is owned by a trust, then we propose that the main home exception apply where 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.

If the major 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. This is to ensure the main home exception cannot be used multiple times through placing property in a trust.

## *Main home*

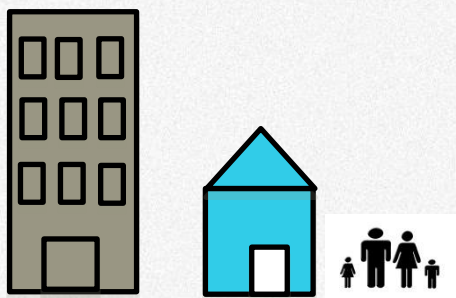
A person should only be able to use the main home exception for one property at a time. To ensure this, we propose for the exception to apply a property needs to be the "main home" of the owner.

Where a person has more than one residence their "main home" is determined according to which property a person has the greatest connection with. The factors that determine these connections would 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
- Whether the person's personal property is in the dwelling



# Example scenarios



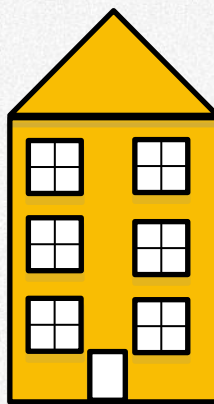
## Multiple homes

Bob has two homes.

His first home is a small apartment in Christchurch which Bob lives in five days a week as he works in Christchurch.

His second home is in Wellington where his family lives. Bob lives in his Wellington home during weekends.

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

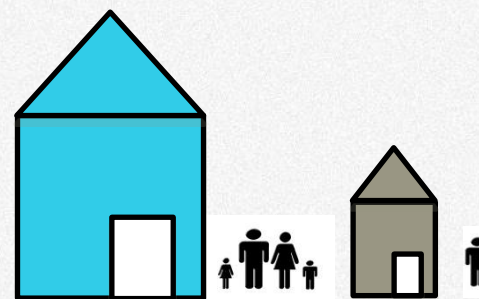


## Rental apartment

Carolyn owns a three storey house.

Carolyn resides on the first floor of the house and rents out the other two floors.

This house would not be covered by the main home exception as the house is not used *mainly* as a residence by Carolyn – its main purpose is instead as a rental property.



## Student flat

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

Dave 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 major settlor of the trust (Dave) has another main home.



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# Submissions on main home

## *Habitual renovators*

Submitters recommended supplementing the rule for habitual renovators in the intention test with a rule for the bright-line.

We agree and are proposing that people cannot use the main home exception if they have already used the main home exception twice in the previous two years.

## *Greatest connection*

Submitters considered that the “greatest connection” requirement would be difficult to apply

We consider that this provision is necessary as a “tie-breaker” to deal with situations where people have more than one-home.

We consider that in most circumstances it will be simple to apply. In boundary situations, existing guidance on ‘greatest connection’ for the existing ‘permanent place of abode test’ could be used to assist.

**Inherited property**



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# Inherited property

## *The bright-line will not cover disposals of inherited property*

This is because a person cannot be expected to have acquired the property with any intention of resale when there is an inheritance

## *Design of inheritance exception*

There are four relevant transfers of property following a death:

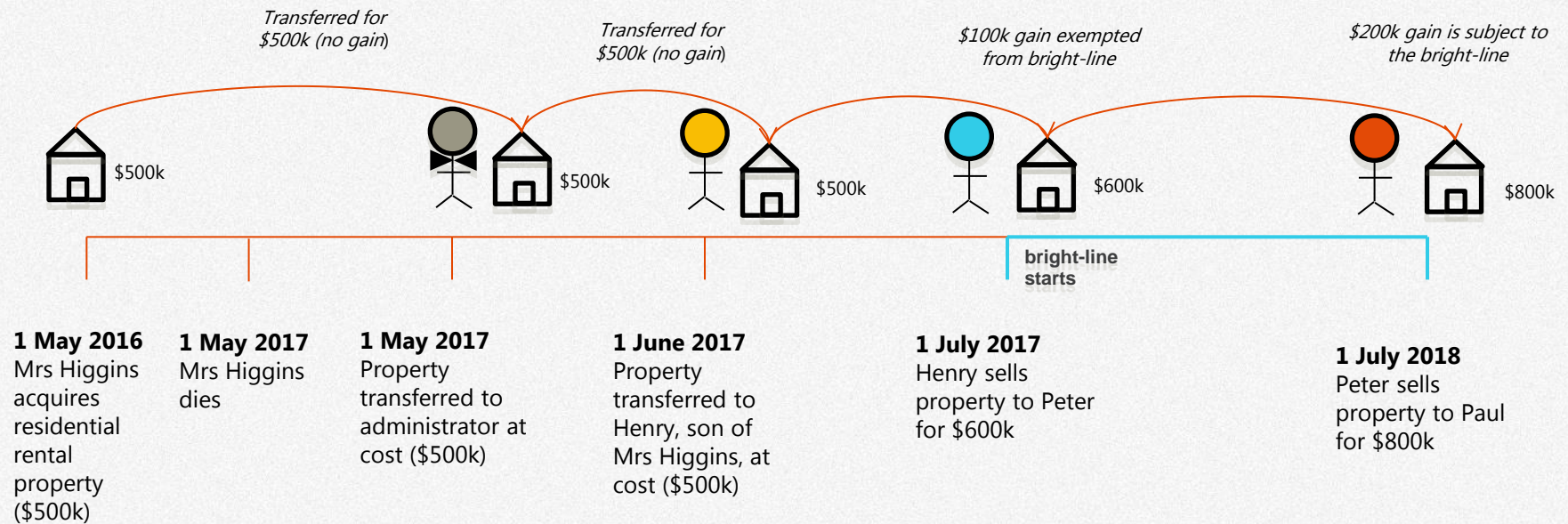
- a) Transfer of property from deceased to administrator
  - b) Sale of property by administrator or transfer of property from administrator to beneficiary
  - c) Sale of property by beneficiary
  - d) Any subsequent sales
- >
- Excluded**
- Not excluded**

We propose that the first three transfers are all excluded from the bright-line. The mechanism for doing so would be:

- Transfers under a) and b) are deemed to have been made at cost
- Sales under b) or c) are exempted from the bright-line

However, a beneficiary may be taxable under the current land sale rules on any subsequent disposal of the property.

# Example scenario





# Relationship property

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# Relationship property

*The bright-line will also not apply to transfers under a relationship property agreement*

However, we think this exception should be narrower than the exception for inheritance.

*Why should the exception be narrower?*

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

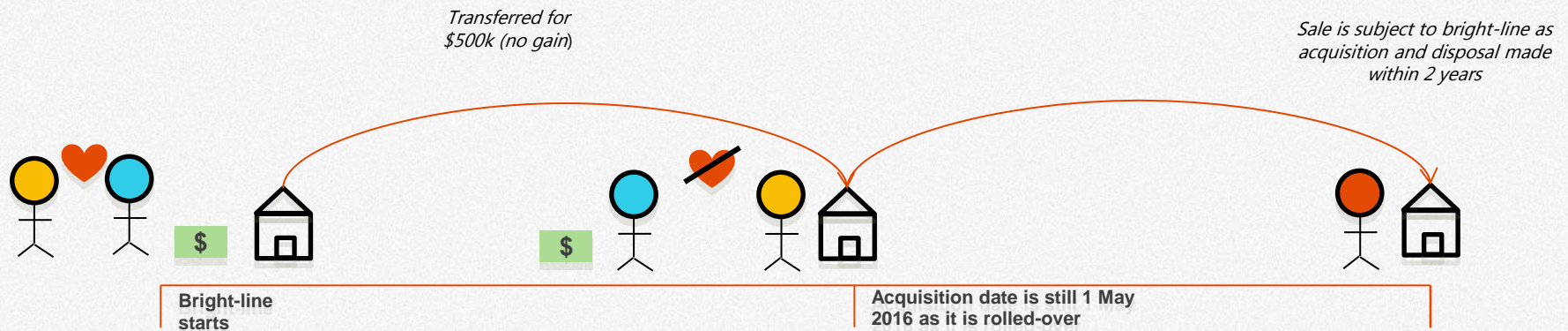
*We think the exception should be the same as the rollover relief available under the current land sale rules*

The current rollover relief deems relationship property to have been transferred at cost. The recipient is then deemed to have acquired the property at the time the transferor originally acquired it.

This means the transfer of property under a relationship property agreement does not trigger the bright-line. However, the bright-line will be triggered if the recipient sells the property within two years of the original date of acquisition.



# Example scenario



## 1 May 2016

Andrew acquires an investment property for \$500k

*Andrew also holds cash of \$500k and Bert has no assets*

## 1 May 2017

As part of a relationship property agreement the investment property is transferred to Bert

## 1 February 2018

Bert sells investment property for \$700k

*In this situation the sale of property by Bert is subject to the bright-line. This is because the date of acquisition by Bert is treated as 1 May 2016 and the date of disposal is 1 February 2018.*

*If the sale by Bert was on 2 May 2018 or later it would not be subject to the bright-line.*

# Deductions



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# Deductions and sales

*The current land sale rules already provide a framework for deductibility*

*Capital costs – always deductible under bright-line*

- Cost of property
- Expenditure related to acquisition (legal fees, surveyors, valuers)
- Incidental costs of subsequent disposal
- Capital improvements – new roof etc.

These will always be deductible under the bright-line as part of the cost of the property.

They will be deductible in the income year the person disposes of the property.

*Holding costs – sometimes deductible*

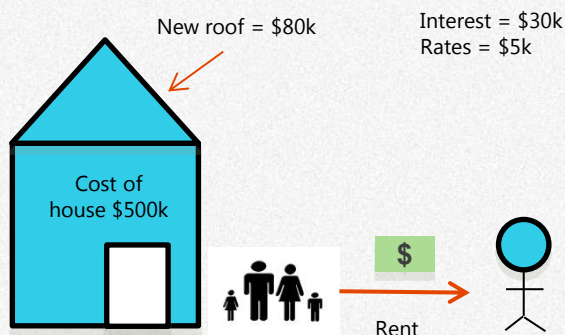
- Interest
- Insurance
- Rates
- Repairs and maintenance

The holding costs will be deductible if they meet the standard deductibility rules ie, the costs are deductible to the extent they have a nexus with income and are not private in nature (or otherwise subject to a general limitation).

Holding costs are generally deductible in the income year | 27  
incurred.



# Example scenarios



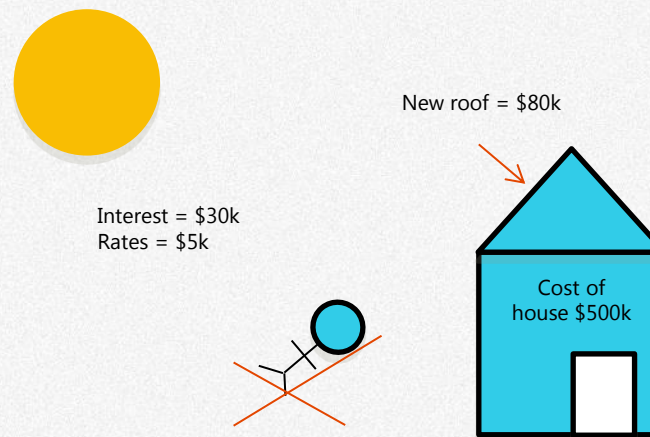
*Rental property*

**May 2016:** Carla buys rental property for \$500k  
**May 2016-31 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  
**April 2 2017:** Carla sells the property for \$800k

**Deductions in 2016-17 year** = \$35k (interest and rates)

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

**Income in 2017-18 year** = \$800k



*Beach house*

**May 2016:** Denise buys beach house for \$500k solely for private use  
**May 2016-31 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  
**April 2 2017:** Denise sells the beach house for \$800k

**Deductions in 2016-17 year** = \$0 – Interest and rates denied by the private limitation

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

**Income in 2017-18 year** = \$800k



**Losses**

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# Losses

*The current land sale rules allow losses from disposals of land to be offset against any other taxable income the seller has.*

*Prima facie fully allowing losses is the correct outcome:*

- It creates symmetry between gains and losses
- This symmetry means we avoid economic distortions

*However allowing unrestrained losses for the bright-line test creates risks:*

- It creates an incentive for taxpayers with unrealised losses to accelerate sales to fall within the two year bright-line period and an incentive for taxpayers with unrealised gains to defer the sale of property till 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 can deduct expenses they would not otherwise have been able to deduct.



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# Ring-fencing losses

*To minimise the risks we propose ring-fencing losses claimable under the bright-line so that they can only be able to be offset against taxable gains on other land sales.*

*Ring-fencing reduces the revenue risks as:*

- Taxpayers have less incentive to accelerate sales unless they have other gains that can be offset.
- Taxpayers have less incentive to defer profit-making sales where they have ring-fenced losses

*Ring-fencing does create a risk of new distortions*

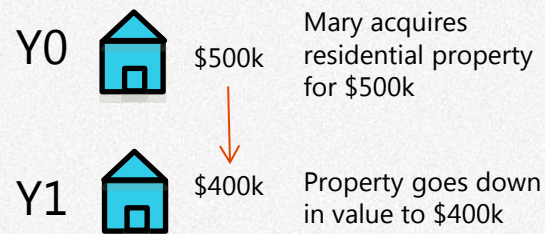
This is because gains and losses are not symmetrical. A person who does not have any offsetable gains will be discouraged from undertaking an investment in residential property .

However, we think this risk is minor:

- Ring-fencing will not affect dealers who buy and sell on a frequent basis.
- 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.

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# Losses from transfers to associated persons



*Mary has been able to realise the loss without any real economic change of ownership occurring.*

Mary wants to realise the loss in the property but does not want to lose control over it.

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

To prevent this, we propose that a person is unable to recognise a loss under the bright-line for a transfer of property to an associated person.



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# Submissions on losses

## *Submitters did not support ring-fencing*

Submissions stated that ring-fencing would:

- Distort decision making
- Create unusable losses for many people
- Be inconsistent with other land sale rules
- Create additional complexity
- Submitters also disputed whether the revenue risk from losses would be significant. Submitters stated that at most accelerating unrealised losses would provide a 33% recovery and the true economic loss is much greater.

## *However, we consider the revenue risk too significant to allow unrestricted losses*

The two-year nature of the bright-line test raises revenue risks above what the current land sale rules do.

This is because a person can ensure that losses are realised while any gains are not realised through accelerating losses and deferring gains.

This risk is particularly great if there was a downturn where a number of people would have unrealised losses and a desire to sell to improve their cash flow.

# Land-rich companies and trusts



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# Land-rich companies and trusts

*The current land sale rules do not apply to the sale of shares in land-rich companies or the change in terms of a trust*

*(However, the sale of shares is taxable if acquired with the dominant purpose of resale)*

*Should there be a rule for land-rich companies?*

The key trade-off for a “land-rich company and trust” rule is between simplicity and accuracy.

There are two options:

- a) Comprehensive land-rich company and trust rules; or
- b) A specific anti-avoidance rule

Comprehensive rules would be more robust and certain, but would be complex.

A specific anti-avoidance rule would be simpler, but would be less robust and less certain.

*Specific anti-avoidance rule*

Comprehensive land-rich company and trust rules would be complex and has a risk of increasing compliance costs.

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 do not think comprehensive land-rich company and trust rules are needed; instead a specific anti-avoidance rule would be better. A specific anti-avoidance rule would aim to deter people from avoiding the land sale rules while not being particularly complex.



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# Specific anti-avoidance rule

## Companies

If a company is:

- a) *Land-rich: 50% or more of the assets of the company is residential land; and*
- b) *50% or more of the shares are disposed of; and*
- c) *The disposal of shares had the purpose or effect of defeating the bright-line*

Then the shareholder is treated as disposing of residential land subject to the bright-line

## Trusts

If a trust is:

- a) *Land-rich: 50% or more of the assets of the trust is residential land; and*
- b) *Either the trust deed changes, the decision maker under the trust deed changes, or an arrangement under the trust changes; and*
- c) *The action in b) was done with the purpose or effect of defeating the bright-line*

Then the trustee is treated as disposing of residential land subject to the bright-line



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# Submissions on land-rich companies/trusts

*Submitters did not support the proposed specific anti-avoidance rule*

- Submitters claimed there would be disproportionate complexity to address a relatively small issue
- Submitters believed the general anti-avoidance rule would be sufficient

*We consider a specific rule is needed to ensure bright-line is not easily circumvented*

A specific anti-avoidance rule provides clear direction that Parliament intended that avoidance through the use of companies and trusts can be dealt with through avoidance rules.

*We are proposing to tighten up the proposed specific rule to address complexity concerns by:*

- Including a definition of land-rich company and trust
- Making clear there would need to be at least a 50% change in ownership of shares to trigger the rule