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Our ref: KPMG submission PUB00316

Team Manager
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12 June 2019

Dear Sir or Madam:

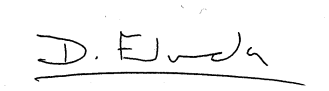
KPMG submissions on PUB00316 - application of the business premises exclusion from the bright-line test and sections CB 6 to 11

KPMG is pleased to make submissions on the above exposure drafts, which are attached to this cover letter. We welcome Commissioner providing more clarity on her interpretation of the business premises exclusion. However, we have concerns about the narrow scope of the businesses premises exclusion.

While we have made separate submissions on the application of business premises exclusion to the bright-line test, in section CB 6A, and the land taxing provisions in section CB 6 to CB 11, the core submission points are the same.

If you would like to discuss either, or both, submissions in further detail, please contact me on 09 367 5940 or John Adams on 07 858 6541.

Yours sincerely



Darshana Elwela
Partner

KPMG submission: business premises exclusion from the bright-line test

Commissioner's draft position

This Exposure Draft concludes:

- Land that has been used predominantly as business premises is not subject to the bright-line test in section CB 6A, even if the land has a dwelling on it.
- Land will be used predominantly as business premises where 50% of the area has been used as business premises for more than 50% of the time of ownership.

KPMG comment

Issue 1: bare land and the business premises exclusion

KPMG submits that the Commissioner's position in respect of bare land and the business premises exclusion for the purposes of section CB 6A is contrary to the policy intent of the bright-line rules.

The bright-line rules apply to "residential land".

Residential land is defined as meaning:

- land with a dwelling on it;
- land for which the owner has an arrangement to erect a dwelling; or
- bare land that may be used for erecting a dwelling under the relevant district plan.

The Exposure Draft states that a taxpayer who disposes of bare land falling under the residential land definition above is not able to apply the business premises exclusion on the basis that business premises requires a building.

We believe that the proposed interpretation is broader in scope than what is intended to be caught per the policy underlying the bright-line rules and the business premises exclusion.

The bright-line rules were established to supplement the section CB 6 intention test in the land tax rules following difficulties in being able to tax speculators in residential investment properties, who were making regular gains from buying and selling property. However given the broad definition of "residential land", the rules have the ability to encompass transactions that are not just residential investment properties.

There a numerous examples where potential overreach will arise. These include:

A "self-sell" car yard example

By way of an example, a business might offer a service where customers wishing to sell their cars, can park their vehicles on a vacant lot that it owns and operate. This "self-sell" concept is similar to that of an ordinary car yard, however there is no on-site manager or a building/office as may be apparent with other car yards.

Depending on the zoning of a self-sell car yard, i.e. if it is residentially zoned with a resource consent to allow for use as a commercial car yard, or if it is one of various commercial zonings which have multiple uses, i.e. commercial or inner-city living, the self-sell car yard would prima-

facie meet the definition of bare land that is also residential land. The central city in Hamilton is an example of an area where mixed zoning applies. Consequently, the disposal of such a self-sell car yard within the five year bright-line period would be technically subject to the bright-line rules on disposal. The business premises exclusion would not apply based on the approach proposed in the Exposure Draft.

Truck depot example

Various logistics operators have off-site locations at which they store or station trucks. These locations do not necessarily have a building erected on them, however the property is used within the business of the various logistics operators. Again, the land may have mixed zoning under the relevant district plans, meaning if the property is disposed of within the five year bright-line period, it potentially would be caught by virtue of bare land falling within the definition of residential land.

The third element of the residential land definition is, therefore, problematic due to its potential width of application.

Presumably, this definition refers to any land under which construction of a dwelling is not a prohibited activity, as a dwelling may be constructed in other cases on application.

In our view, the Exposure Draft should be amended to clarify that the third element of the definition would apply only in the case where construction of a dwelling is a permitted activity. We believe that this better aligns with the policy intention.

The above examples are situations, we believe, where the bright-line rules were not intended to apply and where the business premises exclusion should apply. However, under the interpretation in the Exposure Draft, the disposal of such land would be taxable under the bright-line rules with no exclusion for business premises available.

Other examples where bare land may constitute business premises are quarries, mines, and commercial car parks. In relation to the latter, there may be a simple pay and display method of operation with no building or on-site personnel, with the operator using advanced security technology to monitor the car park remotely. It is nevertheless their business premises, notwithstanding the absence of a building structure.

The policy intention of the bright-line rules was to address untaxed speculation in dwellings and bare land that could be used to erect a dwelling. The above examples fall well outside this desired policy outcome.

Case law

The Commissioner has relied on various case law to take the position that the ordinary meaning of business premises requires a building of some sort.

We refer the Commissioner to case *Thames Water Ltd v Hampstead Homes Ltd [2003] 3 All ER 1304* at 1314 where the Court stated:

> *"Premises", it seems to me, will usually include buildings but may not be limited to buildings and might in some circumstances refer to a place with few or no buildings on it. Premises may in its context also consist of a part of a larger building. A garden centre or a builder's merchant may have premises which include one or more buildings but the premises may extend to the larger site used for the keeping of plants or bricks and sand. A garden centre might conceivably have premises with no buildings on it at all. The premises of a farming business might consist of a group of farm buildings but it would be a somewhat strange context perhaps, though not impossible, which included 100 acres of fields as part of the farm premises. The premises of a large corporation might in context consist of the entirety of a large office block.*

If the Commissioner's overall view remains that the ordinary meaning of "premises" cannot include bare land, we submit that that this issue be referred to Inland Revenue Policy & Strategy for consideration of a remedial legislative amendment to ensure that section CB 6A operates as intended.

Issue 2: Predominant use and the business premises test

The Exposure Draft also establishes that for the business premises exclusion to apply, the land must have been "used predominantly" as business premises. The Commissioner views predominant use as determined based on at least 50% of the physical area being used as business premises for more than 50% of the time.

It appears that the Commissioner is referring only to total land area in this case, rather than floor area.

It is ordinary commercial practice for the predominant use of an asset to be dictated by the highest commercial return able to be derived from the asset.

For example, consider the situation of a 750 m^2 of land that allows a mix of commercial and residential use under the district plan. 350m^2 of the land is occupied as a multi-story commercial building, which produces lease income, with the remaining 400m^2 being vacant land.

Given the land could be used to construct a dwelling under the district plan, it will meet the definition of residential land and would prima facie be subject to the bright-line rules. In economic terms, however, the majority of the value of the land would be attributed to the revenue earning potential of the commercial building, with minimal or no value attributable to the vacant (bare) land.

Under the Exposure Draft, however, all of the land would be subject to the bright-line rules if purchased and sold within five years, due to only the 350m^2 of the land being used as business premises, thereby falling below the 50% threshold under the Commissioner's view of "predominant use".

The above example also clearly falls outside of the intended policy result, in our view.

We submit that predominant use should be able to be determined based on the valuation (which will derive from the income earning ability of the land), not just total physical area. This appears to us to be a fairer test.

KPMG submission: section CB 19 exclusion from sections CB 6 to CB 11

Commissioner's draft position

The Exposure Draft conclusion is that:

- The business premises exclusion in section CB 19 applies to land with a building on it that is occupied by the "landowner" mainly for carrying on a substantial business.
- The section CB 19 business premises exclusion applies only to the extent that the land sold is business premises. Business premises however must have a dwelling of some sort on it. Bare land cannot be a business premises.

KPMG comment

Issue 1: business premises

The Commissioner has relied on various cases to take the position that the ordinary meaning of business premises requires there to be a building of some sort.

As outlined in our submission on the application of the business premises exclusion to bright-line land, we refer the Commissioner to case *Thames Water Ltd v Hampstead Homes Ltd [2003] 3 All ER 1304 at 1314* where the Court stated:

> *"Premises", it seems to me, will usually include buildings but may not be limited to buildings and might in some circumstances refer to a place with few or no buildings on it. Premises may in its context also consist of a part of a larger building. A garden centre or a builder's merchant may have premises which include one or more buildings but the premises may extend to the larger site used for the keeping of plants or bricks and sand. A garden centre might conceivably have premises with no buildings on it at all. The premises of a farming business might consist of a group of farm buildings but it would be a somewhat strange context perhaps, though not impossible, which included 100 acres of fields as part of the farm premises. The premises of a large corporation might in context consist of the entirety of a large office block.*

In our view, the Commissioner has adopted a definition of premises that is unduly restrictive in scope.

The ordinary context of premises and the view taken in the above-mentioned case supports the view that premises can include land without a building structure (so bare land).

In our view, it would be inappropriate to differentiate the tax outcome based on whether land has a building erected on it or not. For example, in the case of land acquired for resale, it is difficult to see why a different tax outcome should arise where the land is used as an outdoor car yard as opposed to an enclosed car showroom, for example.

The view expressed in Example 3 of the Exposure Draft in respect of a scrap metal business is particularly problematic. A reasonable person would clearly accept that the yard would be the premises of a scrap metal merchant. Clearly the merchant must have premises somewhere. If these are not the yard then where could they be?

If the Commissioner's view is that the ordinary meaning of "premises" cannot include land without a building (i.e. bare land), we submit that that this issue be referred to Inland Revenue Policy & Strategy for consideration of a remedial legislative amendment.

Issue 2: Occupied by the landowner mainly for carrying on a substantial business

There is a requirement that the business premises be occupied by the landowner for section CB 19 to apply.

"Occupied" in this context means the landowner (or, for example, their agent or employee) is physically present at the business premises and retains the right to exclude others from the property.

The Commissioner considers that where a landowner leases business premises to a third party, giving them exclusive possession, the landowner does not "occupy" the business premises.

We believe that statements made by Dr John Prebble in *The Taxation of Property Transactions* (Butterworths, 1986) are relevant in this respect.

Dr Prebble comments at paragraph 13.4 (pg. 103) as to how a person may primarily and principally "occupy" a premises. He notes that "occupied" should not be interpreted in the strictly legal sense, but in its ordinary usage. This differs from the Commissioners' narrow legal interpretation in the Exposure Draft.

Dr Prebble further notes that it is established that "occupy" in the context of the land taxing provisions should focus on the reason for a taxpayer's occupation, not to the proportion of the premises that they occupy. The use of "mainly", in this context, refers to the reason for the owners occupation, not the proportion of the premises occupied.

Provided the owner has adequate presence on the premises (which includes bare land, in our view), whether by way of the owners employees or by way of a technology substitute for personnel (such as an automatic ticketing booth or security technology for an unmanned car park), and the main reason for this presence is to carry on a substantial business on the premises, the predominant use test should be able to be met.