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Sir / Madam

KPMG submission - "Income tax – Whether the cost of acquiring an option is part of the cost of acquiring revenue account land"

Your reference: PUB0219

KPMG is pleased to make a submission on this draft Question We've Been Asked ("QWBA") item on whether the cost of acquiring an option is deductible as expenditure incurred as part of the cost of acquiring revenue account land.

In summary, we agree that the cost of an option will form part of the cost of acquiring the land.

However, we consider that this does not provide a complete solution to the question of the deductibility of the cost of the option, nor its timing. Specifically, we disagree with the view expressed in paragraph 25 that the first limb of the general permission (in s DA 1(1)(a) of the Income Tax Act 2007) is not likely to be satisfied on the exercise or expiry of the option. In our view, the scheme of the revenue account property rules, provides a different answer as to deductibility and timing than contemplated in the QWBA.

Analysis

Revenue account to revenue account scenario

We first consider the position where the taxpayer acquires the option to dispose of it and the land acquired on exercise of the option is also acquired to dispose of it. That is, both the option and land are acquired on revenue account.

Cost of land acquired

We agree that the option cost is part of the cost of the underlying land. We accept the analysis on this point in the draft QWBA.

The effect of option exercise on income derived

The Commissioner, at paragraph 24, accepts that exercise (or expiry) of an option is not the disposal of an option. We consider that the option merely ceases to exist. This can clearly be seen because the option no longer exists independently.

In the situation where the option is acquired for disposal, but is then exercised in order to acquire land, this analysis suggests that no disposal arises and no consideration is received for exercise of the option.

The Commissioner accepts, at paragraph 25, that this means that no income arises. We have considered two approaches to test that view:

- A *Sharkey* v *Wernher*[1] type analysis, which is considered part of New Zealand's approach to taxation, could not be applied to deem a market value disposal as the option has not moved from revenue to capital account.
- Section GC 1 will similarly not apply to deem a market value disposition as no disposal has occurred.

We therefore agree with the Commissioner's conclusion that no income is derived at the time an option is exercised.

The general permission and section DB 23

Paragraph 25 notes that the first limb of the general permission (s DA 1(1)(a)) would not be satisfied on the exercise or expiry of the option, as no income is derived. In our view s DA 1(1)(a) merely requires a purpose of deriving assessable or excluded income for the cost to be deductible rather than requiring income to actually arise.

This has been the approach in New Zealand since at least *Commissioner of Inland Revenue v Banks* (1978) 3 NZTC 61,236 at 61,241. The rewrite of the Income Tax Act does not change that approach; it simply reinforces that there is no temporal element to the general permission. The temporal elements to deductibility are dealt with in other sections.

This approach is consistent with, for example, the Commissioner's previously published view on the deductibility of expenses for an investment property, while the property is not let. It is also consistent with the approach to the deductibility of interest under s DB 5 which uses similar wording ("in deriving") to the general permission.

Our view is supported by the timing rule for revenue account property in s EA 2. That provision allows a deduction when "the property ceases to exist". It is counter to the proper construction of the general permission to say that it does not apply because no income arises when the Act specifically allocates a deduction to a time when no income can be expected to arise.

Our conclusion is that the first limb of the general permission is more likely than not to apply if a taxpayer acquires an option to dispose of it. The expenditure is incurred in deriving assessable income that would arise if the property is disposed of (see paragraph 5 and 24 which means that the property is revenue account property so that s DB 23 applies.)

(We have said "more likely than not" as there may be a possible scenario where it does not rather than because we consider in the scenarios discussed in the QWBA that it does not.)

The application of section EA 2

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[1] *Sharkey* v *Wernher* [1956] AC 58 (HL)

As noted above, the cost of revenue account property is deductible when the property is disposed of or ceases to exist under s EA 2. On exercise, the option ceases to exist so that a taxpayer acquiring an option for disposal is able to deduct the option cost at that time.

This result is justifiable on the basis that the sale or termination (expiry or exercise) of the option is an end in itself. The potential income earning process for that property is complete at that point. This is consistent with the Officials report on the Bill which confirms that the different interests in land are separate and should be considered separately.

No double deduction if the land is revenue account land as well

We have agreed that the cost of the option is part of the cost of the land. However, this does not mean that the taxpayer is entitled to deduct the option cost twice. As the draft itself notes at paragraph 26, s BD 4(5) prevents the double deduction of an item of expenditure.

As the item of expenditure in question is the cost of both the option and the land, deducting the expense at the relevant time allowed by s EA 2 (on exercise of the option and on disposal of the land) would be deducting the same item twice. In our view s BD 4(5) would prevent a deduction for the option cost at the time revenue account land is disposed of.

Revenue account to capital account scenario

In this scenario, the taxpayer acquires the option to dispose of it but exercises the option for a capital purpose which means that a disposal would not generate assessable income.

Applying the analysis above, the main effect is that the taxpayer is still entitled to a deduction for the cost of the option under s DB 23 when the option is exercised (the timing allowed under s EA 2) but no income arises.

As with the position on a revenue to revenue exercise of an option, we consider that section GC 1 does not apply.

Additionally, for a *Sharkey v Wernher* type analysis, if the option has ceased to exist it could not be argued that part of the capital account land remains on revenue account. This interpretation is supported by s CB 15B (3).

This result is a consequence of Parliament deeming an option to be a separate item of property and legislating the effect of that. It may be considered to be contrary to policy. However, it is the clear outcome of an application of the rules and the ordinary meaning of the words (as the draft itself shows). If Parliament intended a different result, it could have deemed the exercise of the option to be a disposal. This would have allowed s GC 1 to apply so that the market value of the option at the time of its exercise would have been taxable. Parliament did not make this amendment so the consequence is intended.

(For completeness, although the option cost forms part of the cost of the land, no deduction is available when the land is sold.)

The summary table and examples

In our view, the summary table provided at paragraph 28 should be amended as follows to take account of our analysis above:

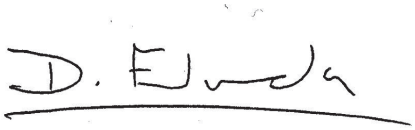
- The reference to the general permission (in the "option not exercised/option revenue account property" box) needs to include the satisfaction of the "incurred in deriving assessable income" limb;
- The two "option exercised when the option is revenue account property" boxes should be amended to provide a deduction for the cost of the option at the time of exercise.
- The "freehold is revenue account property" comment should be amended to say that the cost of the revenue account option is not further deductible when the freehold land is disposed of.

For completeness, we agree that the "option on capital account" summary reflects our view of the correct application of the relevant rules.

Further information

Please contact John Cantin on 04 816 4518, or Darshana Elwela on 09 367 5940 if you would like to discuss our submission in greater detail.

Yours sincerely



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