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Dear Sir

KPMG submission: Bright-line test for sales of residential property Issues Paper

We have reviewed the *Bright-line test for sales of residential property* Issues Paper (the "Issues Paper") and provide our comments below.

General comment

The rationale for the bight-line test is that the intention test in the existing land sales rules can be difficult to enforce due to its subjectivity. We do not believe the introduction of a bright-line test is the appropriate response, as this will add further complexity to an already difficult set of capital/revenue rules for little economic benefit.

This change is an ad hoc and unprincipled solution in our view. For example, it is not clear why the application of the intention test to residential property is more subjective than for other asset classes, such as shares, so as to require a specific bright-line solution.

From a tax policy perspective, we believe this change may well lead to a slippery slope which could result in a proliferation of bright-line tests, for different asset classes, depending on the issue "du jour". (We note the current land sale rules already contain an arbitrary bright-line for those undertaking developments, if the land being developed is sold within 10 years. This will simply add another line in the sand.)

We agree that there are issues with the application of the current capital/revenue tests, but these need to be looked at, and addressed, in a comprehensive and coherent manner, not on a piecemeal basis.

We also believe that Inland Revenue's seeming unwillingness to apply the current rules more robustly may well be self-fulfilling. That is, poor enforcement will have contributed to the perception that the intention test is too difficult to apply.

We also provide comments and our recommendations on specific aspects of the suggested bright-line test below.

Economic impact

The Issues Paper concedes that people who do not sell property on a frequent basis “perform a relatively small economic function in the housing market”. Those who sell property on a frequent basis should generally be taxed under the intention test in the current land rules as frequency of trading tends to create a nexus with an intention of sale. However, as noted above, the current enforcement of the rules is an issue. Therefore, assuming the current rules could be better enforced by Inland Revenue for those selling residential property on a frequent basis, it is unclear what real economic benefit can be taxed through the introduction of the bright-line test which focuses on those who do not sell property frequently. The marginal impact of the bright-line test will be to tax those transactions which ought not to be taxed.

The bright-line test will apply where a taxpayer did not buy property with a purpose or intention of resale, but due to financial or other circumstances (such as loss of employment, relationship breakdowns, or an increase in financing or holding costs) is required to dispose of the property within the two year period. Ex-ante, there is no economic benefit to tax in such circumstances, but this will nevertheless be caught under the proposal.

“Start” and “end” dates for measuring the two year period

We note that the start date for the bright-line test will be defined differently to that under the existing land sale rules. The rationale for making registration date the start date for the bright-line period – that it will be difficult for sellers or Inland Revenue to track the date of the original purchase contract – does not stack up in practice. This also has the effect of “extending” the bright-line longer than two years.

We consider that the definition of the start date under the existing land sale rules is sufficiently clear and in the interests of consistency and avoiding confusion, the date of acquisition under the bright-line test should be the same as for the other land sale rules in subpart CB of the Income Tax Act 2007.

We note that this approach would also mean that a specific rule for “off the plan” sales and purchases is not required.

Disposal under insolvency

We consider that the transfer of property from an insolvent person to the Official Assignee should not be a disposal for the purposes of the bright-line test. The disposal should be deemed to occur when the property is sold by the Official Assignee.

Definition of “residential land”

The proposed definition of “residential land” at 4.3 of the Issues Paper is land that has a dwelling on it, or for which there is an arrangement to build a dwelling on it, excluding farmland and business premises.

We note that “arrangement” is defined in section YA 1 of the Income Tax Act 2007. We assume that this is the intended definition so that, for example, the presence of a residential subdivision plan would constitute an arrangement. However, it would be helpful to have the effect of this definition explained.

Use of GST definition of dwelling

The Issues Paper proposes a new definition of "dwelling" (in the Appendix). We note that this definition is not the same as the definition of "dwelling" in the Goods and Services Tax ("GST") legislation. In our view, it is sensible to have a single definition which applies to both Acts but which is modified as and where necessary. This will assist with compliance.

Rest homes or retirement villages

While the proposed definition excludes "a rest home or retirement village", the definition in the GST legislation has been modified to include residential units in rest homes or retirement villages. We assume that such dwellings are not intended to be subject to the bright-line rule (i.e. it is assumed that it would be an occupier's main home). The GST definition would therefore need to be modified to exclude such units for the purposes of the bright-line test, if that definition is used.

Serviced apartments

We refer to comments made at 4.5 of the Issues Paper in regard to serviced apartments. It is unclear whether a serviced apartment is considered to be business premises because of the presence of an office from which the owner of the property works from. However, we note that if the GST definition is used, a serviced apartment business would be a commercial dwelling and not subject to the rule.

"Main home" definition

The Issues Paper considers that the bright-line test provides objectivity and unambiguity in the taxation of gains from residential property. While we agree that the subjective nature of the intention test can make the taxation of gains problematic, we are not convinced that the bright-line test achieves the objectivity and, therefore, the level of certainty envisaged or desired.

Based on the Issues Paper, it is intended that the determination of the main home would be similar to the tests used to determine a "permanent place of abode" for tax residence purposes. The application of these tests, in a tax residence context, has been historically problematic due to their reliance on facts and circumstances. Further, as Inland Revenue is aware, the guidance provided is long and detailed and subject to dispute, most recently in the *CIR v Diamond* case.

The practical application of the main home test will therefore introduce additional uncertainties, in our view.

It is also not clear why the criteria in the existing residential property exemption in section CB 16 of the Income Tax Act 2007, which appears have the same purpose, is not used to define the "main home" exemption under the bright-line rules. This approach is supported by the fact that the proposed bright-line test is meant to be a proxy for section CB 6, which is subject to the residential land exclusion in section CB 16.

In terms of practically applying the exemption, it is unclear at what point and/or over what timeframe in the two year bright-line period a property must be the “main home” for the exemption to apply. For example, is the intention that the “occupied mainly as a residence” requirement be met at all times during the two year bright-line period, for the majority of the time during the period, or only at or around the time of sale? This will need to be clarified and guidance provided to minimise uncertainty.

We note that a full two year period of occupation for the main home exemption to apply will not be feasible if the start date for the bright-line test is the date of the contract to purchase as recommended. This is because the property is unlikely to be occupied between the contract date and date of settlement.

Trusts

Complexity will also arise where residential property is held through a trust. For example, if the parents settle the family home on trust for their children, or “mirror” trusts are used, the application of the main home exception may be problematic. Trustees may also not be aware if a settlor or a beneficiary otherwise has a main home.

Further, applying section CB 16(1)(b) as the basis of exemption would properly allow a property occupied by a beneficiary to be exempt from the bright-line test.

Exemptions for inherited property and relationship property

We agree that the sale of inherited property should not give rise to a tax liability under the bright-line test on the basis that a transferee following a death does not have a choice to acquire property.

We agree with the approach taken in the Issues Paper that a transfer of residential property under a relationship property agreement should not trigger the bright-line test. However, we disagree with the rationale for distinguishing between the tax treatments of subsequent sales of inherited and relationship property.

One of the stated rationales for distinguishing the treatment on sale of relationship property to that of inherited property is that *“a transferee following a death does not have any choice about what property is transferred to them; in contrast, there is more opportunity to negotiate the property that a transferee receives under a relationship property agreement”*. This assumes that relationship property transfers will be amicable, which will not always be the case. Therefore, we believe that further consideration needs to be given to the subsequent sale of relationship property.

Further, if one of the reasons for applying the bright-line test to subsequent disposals of relationship property is that it can be presumed that both parties had a joint purpose or intention in relation to the property when acquired, then the start date should be the original purchase date, not the subsequent transfer date.

Deductibility of holding costs

We are concerned with the view in the Issues Paper that notwithstanding a sale within two years being taxable, under the bright-line test, holding costs (such as interest, insurance, rates, and repairs) may not be deductible if there is insufficient nexus with income. The Issues Paper suggests that the property must be rented or be part of a business or profit making scheme for holding costs to have nexus with income and be deductible.

We strongly submit that holding costs should be deductible where residential sales will be taxable under the bright-line test. The taxing event on sale creates the required nexus for the expenditure to be deductible.

Ring-fencing rule for losses

There is no tax policy justification for ring-fencing losses, generated under the bright-line test, when a gain from sale will always be taxable. Ring-fencing will create losses that will be unusable as it is unlikely that people who do not sell property on a frequent basis will generate taxable gains under the bright-line test (or the land sale rules generally) subsequently. Loss ring fencing therefore effectively represents a one way bet for Government, which is unfair.

Further, it is proposed that the loss ring-fencing rule will not be applicable if the disposal is taxable under one of the current land sale rules instead. This will create an incentive for taxpayers to argue that the property was acquired with the intention of resale to offset the loss.

We understand that loss ring-fencing has been proposed to protect the revenue base. However, if as previously discussed the bright line test will mainly capture people who do not sell on a frequent basis (as those who do will be able to claim losses under the current land sales rules) there is potentially little fiscal benefit, but a whole lot of complexity, from introducing a loss ring-fencing rule.

Land-rich companies and trust anti-avoidance rules

Given the impact of the bright-line test, we do not believe specific anti-avoidance provisions are warranted. These will create disproportionate levels of complexity for very little revenue gain. If rules are needed, we consider a specific anti-avoidance rule would be the better option compared to a comprehensive set of new anti-avoidance rules. However, we have a number of concerns about its practical application.

The example provided at 9.8 of the Issues Paper states that the proposed anti-avoidance rule would deem a disposal of the 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". The taxable amount will be the gain made on the sale of the shares.

We have the following concerns with a targeted rule:

- It will not be able to be easily applied if the company holds multiple properties, with some properties held for less than two years and others for more than two years at the time the shares are sold. For example, will any gain on sale of the shares need to be pro-rated according to the market value of properties held for less than two years? Also, it is not clear what level of shareholding change in the company will be needed to trigger the proposed rule. If only some of the shares are sold, will this be treated like a partial sale of the underlying property? There are therefore genuine workability and practical concerns around such a rule which will need to be worked through.

- It is not clear whether the circumvention purpose or effect is intended to be the dominant effect or purpose, the only effect or purpose, or whether this simply can be one of multiple purposes or effects, for the anti-avoidance rule to be triggered. (We note section BG 1 of the Income Tax Act 2007 applies if tax avoidance is one of the purposes or effects of an arrangement, but not if the tax avoidance purpose or effect is merely incidental.) How the specific rule will be triggered needs to be clarified, in our view.
- We note that a subsequent acquirer of shares in a land rich company would be able to avoid the bright-line rule as it does not appear that the acquisition of the shares in the company would "reset" the date of acquisition of the underlying property by the company. Shareholders would therefore be able to transact freely in the shares of the company, if that is more than two years after the property is acquired by the company, without the bright-line test applying. It is not clear that this outcome is intended. If not, to bring this under the bright-line test, it would be necessary to modify the date of acquisition of the properties each time the shares are sold. This will create additional complexity in the rule.

We note that "land-rich" company has not been defined in the Issues Paper and there is no comparable definition in the Income Tax Act 2007. (We note that the PIE rules contain a definition of "land investment company", however this is in the non-residential property context and that definition has different drivers.) A definition similar to that in New Zealand's Double Tax Agreements, for shares in companies the assets of which consist wholly or principally of "real property" (real property includes land or interests in or over land), or where 50% or more of the value of the company is attributable to land, could be adopted.

Trusts

We consider that a change in the trustees of a trust (or ownership of the trustee) should not trigger the proposed anti-avoidance rule. Replacement of trustees is common place. Alternatively, if this is retained, there should be an exemption for change of an independent trustee (such as one of the public trustees), as this will not be done to circumvent the bright-line test.

We believe that the anti-avoidance rule for trusts should only apply if there is a change in the beneficiaries of the trust, and only a material change to beneficial entitlements at that, having regard to complexity and unintended consequences of the rule relative to the potential revenue at risk.

Further information

If you wish to discuss this submission in any further detail, please contact us, John Cantin on 04 816 4518 or Darshana Elwela on 09 367 5940.

Yours sincerely

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