KPMG

TaxMail

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Regular commentary from our experts on topical tax issues

Issue 1

Budget property tax rules will ring fence losses

The issues paper on the two year bright-line test announced in Budget 2015 highlights the complexity and some unwelcome features of this rule

One such feature, which was not signalled in the Budget, is to ring fence losses against other land income (i.e. taxable gains on other land sales). This is not justified from a policy perspective

Snapshot

In Budget 2015 Government announced that sales of residential land (other than the main home and limited other cases) within two years would be taxable, for acquisitions on and after 1 October 2015.

Inland Revenue has released an issues paper on how this new "bright-line" test will work, including a proposal to ring fence losses generated under the rule to other land income. Submissions are requested by 24 July.

Also from 1 October, buyers and sellers will need to provide their IRD number and non-residents (and other "offshore persons") will need to have a New Zealand bank account to get an IRD number.

The Government has introduced draft legislation – the Taxation (Land Information and Offshore Persons Information) Bill – to collect IRD number and other tax information from property buyers and sellers. The Bill clarifies the requirements, including defining an offshore person.

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What's proposed?

Two year bright-line test for residential property

The Issues Paper contains more detail on how the bright-line test will apply:

- The new rules will generally apply where an agreement for sale and purchase is entered on or after 1 October 2015.
- The two year period will be measured from the date title is registered for purchase of property to the date a contract for sale (i.e. a sale and purchase agreement) is entered into. This rule will be modified when disposal is by gifting and for sales of subdivided lots and "off the plan".
- "Residential land" will be defined as land with a dwelling on it, or where there is an arrangement to build a dwelling, and will exclude land used predominantly as farmland or for business premises.
- There will be an exception for the "main home". This is defined as the dwelling which is occupied mainly as a residence by the owner. There are special rules for property owned through trusts.
- There is also an exception for inherited property (a beneficiary will not be taxable on any future transfer) and on relationship property transfers (any subsequent sale will be subject to the two year rule).
- Losses under the bright-line test will be ring fenced, meaning they can only be offset against income arising under the land taxing provisions (i.e. taxable gains on other land sales). Losses on sale of property to associates will be disallowed altogether.
- Special anti-avoidance rules are proposed to stop the rules being circumvented by holding residential land in companies or trusts (and selling the shares instead of the land or varying the beneficiaries of the trust).

IRD number and other disclosure requirements

Under the draft legislation, from 1 October 2015:

- Buyers and sellers of land will need to provide their IRD numbers to a property conveyancer, such as a lawyer, as part of the land transfer process. A New Zealand individual will be exempt from this requirement if the sale relates to their main home. They will not be able to rely on the main home exemption more than 2 times in the 2 years prior to sale.
- Conveyancers will need to provide the relevant information prior to certifying a property transfer. The tax information must be provided to Land Information New Zealand which will in turn provide it to Inland Revenue. IRD numbers and other tax disclosure information will not be made publicly available.
- "Offshore persons" will also need to provide their home country tax identification number and have a New Zealand bank account to get an IRD number. An offshore person is defined as: individuals that are not NZ citizens or permanent residents, NZ citizens who have not been to NZ for at least 3 years, NZ resident visa holders who have not been to NZ for at least 1 year, and entities that are 25% or more owned or controlled by offshore persons.

Who should take note?

As noted in our Budget taxmail, the two year rule will be a particular focus for residential property investors while the need to provide IRD numbers provides a simple means of matching a buyer and seller of property with Inland Revenue's records. Non-residents having to provide foreign tax identification numbers will also allow for better information sharing between Inland Revenue and their home jurisdictions.

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Our view

The devil is really is in the detail

The issues paper highlights the potential complexity of the new bright-line test as well as some of its unexpected (and unwelcome) features.

The "start" and "end" dates for measuring the two year-period. The proposed start date for the bright-line test – the date of registration of title – differs to the start date under the land taxing rules generally (which is the date a sale and purchase agreement is entered into). The start date in the existing land rules is clear and well established. We see no reason for a different start date for the bright-line test. This will simply add to the complexity of the new rules.

What's the main home? Where a person has several residences, the proposal is to introduce a Permanent Place of Abode test to determine the main home. The practical application of that test, which is normally used to determine an individual's tax residence, can be difficult – e.g. where time is split equally and other factors are finely balanced. It is also unclear at what point a property must be the main home for the exception to apply – i.e. at the time of sale, at all times during the 2 years, the majority of the time?

Complexity will also arise where residential property is held through a trust. For example, if parents settle the 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 is using the main home exception.

Different rules for inheritances and relationship property transfers. The latter will be subject to the new taxing rules, if the recipient of the property transfer subsequently sells the property. The difference in treatment is justified on the basis that a transferee following a death does not have any choice about what property is transferred to them while, in contrast, *"there is more opportunity to negotiate the property that a transferee receives under a relationship property agreement"*. Depending on the circumstances surrounding a relationship property transfer, this will not always be the case.

Holding costs will not necessarily be deductible. Notwithstanding a sale within two years being taxable, holding costs (such as interest, insurance, rates, and repairs) will only be deductible if the normal deductibility requirements are met. The issues paper suggests 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. As the bright-line test will make certain residential property sales automatically taxable, this should be sufficient for nexus with income to deduct holding costs.

The ring fencing of losses is not justified. This feature was not signalled in the Budget announcements. Officials' concern is that this is necessary to stop losses being brought forward. However, this incentive currently exists under the land taxing provisions. There is no tax policy justification for loss ring fencing when the gain will be fully taxable as income. Loss ring fencing is one of the classic concerns with a capital gains tax as it effectively represents a one way bet for Government.

Further, loss ring fencing would not apply if the normal land rules also apply. It is unclear, therefore, what would stop taxpayers arguing that they acquired residential property with the purpose or intention of resale, to claim the loss.

Anti-avoidance rule – the proposed anti-avoidance to capture land rich entities will create uncertainty. For example, it is unclear how "land rich" will be defined. For trusts, it is proposed that a change of trustee will trigger this rule. A change of trustee will be commonplace. This, in and of itself, should not trigger the rule. Further consideration therefore needs to be given to the design of this rule to ensure it is appropriately targeted.

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Holding for more than 2 years will not be a "safety net" from being taxed

It is important to note that the proposed bright line test does not automatically exempt sales made after two years. Those sales continue to be subject to the normal land taxing rules (e.g. will be taxable if the property was bought with the purpose of resale).

Next steps

The issues paper provides an opportunity to respond to the detail of the bright-line test, while submissions on the draft legislation on the additional information requirements are due by 9 July.

Both sets of changes will need to be enacted by 1 October this year, which is a tight time frame. Therefore, the scope for any significant revision appears limited.

For further information

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