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The Chair
Finance and Expenditure Select Committee
Parliament Buildings
Wellington

Our ref 150917KPMGSubBrightLineBill

17 September 2015

Dear Sir or Madam

KPMG submission - Taxation (Bright-line Test for Residential Land) Bill

KPMG is pleased to make a submission on the Taxation (Bright-Line Test for Residential Land) Bill (the "Bill"). Our detailed submission points are attached.

Our general view is the bright-line test for residential land imposes a specific capital gains tax on those forced to sell within two years. This is illustrated in our attached submissions. We consider that the tax information to be provided by sellers from 1 October 2015 may mean that the bright-line rule is unnecessary and therefore its implementation should not proceed.

We raised concerns about features of the bright-line test during consultation on the proposal. Disappointingly, many of those concerns are not addressed in the Bill. We reiterate our key concerns in the specific submissions which are attached. We believe these warrant consideration by the Finance and Expenditure Select Committee (the "Committee").

Given the short time available, we have necessarily focussed on the issues that we have found. It is likely that there are others. Further, due to the nature of policy development for the various parts of the Government's property tax policy, it is also likely that there will be inconsistencies.

We recommend that all three parts of the policy should be considered when the final part (the proposed Residential Land Withholding Tax) is being consulted on by Officials and by the Committee when the relevant Bill is referred to it.

Further information

KPMG would be pleased to appear in front of the Committee to discuss our submission. We can be contacted on 04 816 4518 (John Cantin) or 09 367 5940 (Darshana Elwela).

Yours sincerely

JJ Cantin

D. Elwela

John Cantin
Partner

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National Tax Director

KPMG's general submissions

Our general submissions are as follows.

Rationale for the bright-line test

Submission

While acknowledging that the bright-line test is Government policy, and part of its Budget 2015 commitments, we submit that the rationale for the proposal and its application need further consideration by the Committee.

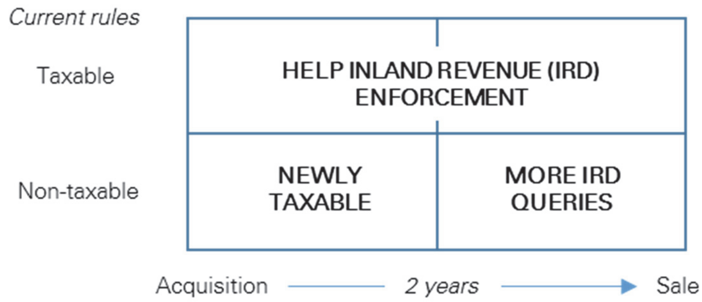
Comment

The perceived problem is that the existing intention test, whether residential land is "acquired with the purpose or intention of resale", is difficult to enforce due to its subjectivity. While we generally agree with this statement, we believe it applies to the intention test generally. Therefore, the application of the current capital/revenue tests need to be looked at in a comprehensive and coherent manner, not on an ad hoc basis. The proposed bright-line test for residential land is an ad hoc approach.

The bright-line test raises the following questions and issues:

1. Why is the application of the intention test to residential land inherently more subjective than for any other asset, such as shares, so as to require a specific bright line solution? We believe this change may well lead to a proliferation of bright-line tests, for different asset classes, depending on the "issue of the day". This is not a principled basis for tax policy development.
2. We believe Inland Revenue's inability to apply the current rules more robustly has exacerbated the problem. This has contributed to the perception that the intention test is too difficult to apply. Better enforcement of the existing rules is a preferable option, in our view, to introducing further legislative complexity.
3. Those who sell residential land on a frequent basis should generally be taxable under the intention test. The frequency of trading should create a sufficient nexus with an intention of sale so that a relevant exemption would need to be shown to apply. The bright-line test will therefore only tax those who have not bought with the purpose or intention of resale, but are required/forced to dispose of the land within the two year period. This may be for involuntary reasons, such as financial hardship. This is not the intended target of this rule.

The diagram below illustrates the effect of the bright-line test. It does not alter the position for those who are taxable under the current land sale tax rules. It will tax those who would not otherwise be taxable if they sell within two years. This means that, to the extent the tax position affects a decision to sell or not, the bright-line test will apply to those who are currently non-taxable under the existing rules and are forced to sell within a two year period.



We consider that this outcome means the bright-line rule is correctly described as a specific capital gains tax.

The land transfer tax information should be sufficient

Submission

We submit that the bright-line rule is not required as tax information to be collected from sellers (and buyers) of land from 1 October 2015 should be sufficient for Inland Revenue to enforce the current rules.

Comment

In Budget 2015, the Government announced it would:

1. Collect tax information (such as IRD numbers) from property buyers and sellers (this is included in the Taxation (Land Information and Offshore Persons Information) Bill).
2. Tax residential land bought and sold within 2 years (the “bright-line” test in the Bill).
3. Look at a withholding tax for offshore sellers (currently being consulted on by Officials in the *Residential Land Withholding Tax* issues paper).

Although each of the three parts of the above policy are said to have regard to each other, given our view that the current problem is one of the ability of Inland Revenue to enforce the rules, there is no apparent consideration of whether all three parts are actually required.

We acknowledge that a fair response from Inland Revenue would be that its ability to enforce the current rules is hampered by the lack of information about land transactions. The tax information proposed to be collected from buyers and sellers under the Taxation (Land Information and Offshore Persons Information) Bill should provide Inland Revenue with the relevant information.

For example, it will provide information on the date of acquisition and date of sale of the land and whether the seller has used the property as their main home. This should make it simpler for Inland Revenue to enforce the current rules, as well as significantly increasing taxpayer self-assessment and compliance.

The advantage of relying on the new tax information requirements is that the bright-line test, which in effect taxes capital gains, will not be necessary.

Problems arising from piecemeal development of the overall policy

Submission

We submit that the coherence and consistency of the overall policy should be considered as part of the Bill containing the third part (the Residential Land Withholding Tax). If necessary, remedial legislation for the first and second parts (the bright-line test and tax information requirements) should be considered as part of that Bill.

Comment

The different parts of the overall policy has been developed in a piecemeal fashion and at speed. In our view, this means there is a risk of inconsistency and potentially incoherence.

We have noted in our detailed submission points areas where the rationale for one part of the package is inconsistent with the rationale for a design feature for another part.

Further, as the potential withholding tax rules are considered, it is likely that further anomalies will be found. The impact on the tax information and bright-line test requirements will need to be considered accordingly.

KPMG's specific submissions

Notwithstanding our general submissions, if the bright-line test for residential land proceeds, we make the following submissions on the detail of the proposal.

Summary

Compulsorily acquired land	Should not be subject to the bright-line test if this occurs within 2 years of acquisition
Beginning of bright-line period	Should be aligned with the acquisition date for the purposes of the land sale tax rules generally
Leases of residential land	Should be explicitly excluded from the application of the bright-line rule if the lease terminates within 2 years
Residential land	Should be land which is zoned residential and farmland should include land with an existing farming business
Main home exemption	Should not proceed. The residential exemption in section CB 16 should apply instead. In the alternative: • The detailed application of the main home tests; • The ability of a person not residing in New Zealand to use the main home exemption; • The ability to have multiple main homes; and • The ability for a trustee to use the exemption if the settlor is not otherwise claiming the exemption should be legislatively confirmed
Inherited property and relationship property transfers	The treatment should be aligned
Holding costs	Should be deductible
Loss ring fencing	Should not proceed
Land-rich company and trust avoidance rules	Should not proceed
Non-filing for a non-active trust	The filing threshold should be more than $500 of non-source deducted income

Exemption from bright-line test where land is compulsorily acquired (no clause)

Submission

We submit that the bright-line test should not apply to residential land that is compulsorily acquired.

Comment

Where residential land is compulsorily acquired within the bright-line period (e.g. under an Act of Parliament or on the foreclosure of a mortgage), the bright-line test should not apply. Such a disposal will be involuntary and it is therefore unlikely that the land was acquired to sell and subject to tax under the intention test (in section CB 6). As new section CB 6A is intended to be a proxy for the intention test, it should not apply to compulsory disposals.

Start date for measuring the bright-line period (clause 4)

Submission

We submit that the start date of the bright-line test period should be the acquisition date of the land determined consistently with the other land sale tax rules in subpart CB.

Comment

Registration, rather than the acquisition date, has been justified for the commencement of the bright-line period because Officials consider it to be difficult for sellers or Inland Revenue to track the date of the original sale and purchase contract.

This reasoning is difficult to accept. Further, it is contrary to the stated objective (see page 4 of the Regulatory Impact Statement of the Bill) of minimising the number of sales made taxable that were acquired without an intention of resale.

Clarity of the rule

We consider the acquisition date under the existing land sale tax rules is sufficiently clear. We note that there is support for that proposition in the Commissioner's own recent draft statement on the date of acquisition of land under section CB 15B (*PUB00220: Income Tax – Date of Acquisition of Land*). We assume that the Commissioner would not have released the draft statement unless she considered her analysis to be clear. (We note that this item is subject to consultation but we would expect that any changes should result in more, not less, clarity about the application of section CB 15B).

Practicality

We also consider that determining the date of acquisition should not be problematic in practice. Sellers' agents (such as their lawyers) will typically have this information at hand. We would expect that most sellers, particularly if the sale is within a two year period, will have used the same lawyer for the purchase of the land. If so, the lawyer should be able to confirm the date that the original purchase was binding. It is likely that the lawyer will have notified the vendor that the original contract was binding. The information should therefore be readily available.

We refer in support of this proposition to the Officials' issues paper *Residential Land Withholding Tax*. Paragraph 3.22 states (in the context of determining whether the seller is an offshore person):

> *In addition, the vendor's conveyancing agent is likely to be familiar with their client's personal situation.*

We agree. In our view, this can be expected to be the case for the vast majority of cases.

Where that is not the case, consideration could be given to ensuring that the conveyancing agent is provided the relevant information. The tax information statement provided by the seller should contain that information.

The bright-line test should not unnecessarily be extended to those who would not be taxed under the current rules. As currently drafted the Bill's start date for the bright-line period will unnecessarily extend the rules.

We note that using the acquisition date as the start date would also mean that a specific rule for "off the plan" sales and purchases is not required. This would simplify the rules.

Definition of "Estate" in land – leases (clause 15 – section YA 1 definition)

Submission

We submit that as leases (and licences) over residential land are not the focus of the bright-line test it should be clarified that the bright-line rule only applies where there is an interest which confers legal ownership (or similar) over residential land.

Comment

The Bill proposes a new definition of "estate" in relation to land which also includes an interest in land. An estate or interest in land will include a right to possession of the land.

This means that leases of and licences to occupy residential land will also be caught by the bright-line test, if the lease (or licence) terminates within two years of being entered into. This means there is a potential for a single property to be technically within the bright-line test multiple times as residential leases are entered into and terminated. (We have not provided the detail of our analysis but can do so if the Committee considers this would be helpful.)

We do not believe this outcome is intended. (We do note that practically there may be no income or loss to be taxed. However, there will be unnecessary compliance costs in confirming that is the case.)

We again refer to draft PUB00220 which confirms the Commissioner's view that a particular property may generate different estates or interests in land. The new definition of "estate" would not, in our view, change that approach.

Further, the Commissioner's draft statement (*PUB0219: Income Tax – Whether the cost of acquiring an option is part of the cost of acquiring revenue account land*) states that the termination of an option over land is a disposal of that interest in land for the purposes of the land rules. The logical consequence of this position is that the termination of a lease is a disposal of an interest in land.

We note that current section CC 1B may contain a definition of leasehold estate which may be suitable to achieve our submission.

Definition of "Residential land" (clause 15 – section YA 1 definition)

Submission

We submit that the definition of "residential land" should be amended such that:

- Bare land that because of its area and nature is capable of having a dwelling erected on it is limited to land zoned for residential purposes.
- Any land where there is an existing farming business, regardless of profitability, should qualify for the exemption from the bright-line test.

Comment

The proposed exclusion for farmland is limited to "land that because of its area and nature is capable of being worked on as an economic unit as a farming or agricultural business".

The Bill commentary states that the relevant test for an economic unit is whether the land is capable of generating revenue sufficient to cover the cost of capital and provide a return for the owner. In practice, this may be a difficult test to meet as some farming ventures will not, initially at least, provide a return sufficient to cover all of the costs. This then raises questions about the period of measurement and how Inland Revenue could enforce this rule.

To prevent confusion, farmland should be defined simply as "land that is capable of being worked on as a farming or agricultural business".

"Main home" exemption (clause 6 and clause 15 – section YA 1 definition)

Submission 1

We submit that the proposed "main home" definition and exemption is unnecessary.

Comment

There is a principal residence exemption in section CB 16 which applies for the purposes of the intention test (section CB 6). Given that proposed section CB 6A is meant to be a proxy for the intention test, we consider that the exemption should be that which is applied for the purposes of section CB 6.

This is likely to eliminate the uncertainties which are inherent in proposed section CB 16A.

Submission 2

If the above submission is not accepted, we submit that further guidance is needed in the legislation on the application of the main home exemption.

Comment

The proposed definition states that a main home means the dwelling that is "mainly used as a residence by the person" or the dwelling "with which the person has the greatest connection, if they have more than 1 home".

In relation to the latter, the Bill commentary suggests that a person's ties to each dwelling will need to be evaluated. The relevant tests here include the time the dwelling is occupied, where the immediate family of the person live, where the person (and their family's) social ties are the strongest, and the location of personal property and employment and business ties.

These tests appear to be modelled on the tests for determining whether a "permanent place of abode" arises for tax residence purposes. The application of the tests, in a tax residence context, has been historically problematic due to their reliance on facts and circumstances. Further, the tax residence guidance is long and detailed and subject to dispute, most recently in the *CIR v Diamond* tax residence case.

Proposed section CB 16A states that the bright-line test does not apply if "the land has been used predominantly, for most of the time the person owns the land, for a dwelling that was the main home". The Bill Commentary states that this is intended to be a two-pronged inquiry:

- Has more than 50% of the land area been used as the person's main home; and
- Has the property been used for more than 50% of the time it is owned as the person's main home?

We submit that it would be useful for the detail of the "greatest connection" test and the "predominantly used, for most of the time, as a main home" test, outlined in the Bill commentary, to be explicitly legislated for, rather than published in the Tax Information Bulletin when the legislation is enacted.

We note particularly that statements in a Tax Information Bulletin are not treated as binding statements of the law by the Commissioner, but rather purely as statutory interpretation aids. The Commissioner will interpret the legislation using accepted statutory interpretation rules which do not give such statements determinative status. This means that the statements in Tax Information Bulletins are ultimately not reliable. We do however acknowledge the practical benefit of such statements.

Submission 3

We submit that the ability of a person not residing in New Zealand to claim the main home exemption needs to be clarified.

Comment

The Bill commentary states that if the owner of a property does not reside in New Zealand, they cannot use the main home exemption. We can see no such restriction in the main home exemption in new section CB 16A of the Bill.

We note that the Taxation (Land Information and Offshore Persons Information) Bill does not allow a person to use the main home exemption if they are an offshore person. It is not clear if this is the exclusion that is meant to be mirrored in the bright-line test.

For example, if the owner is no longer residing in New Zealand (and does not own residential land in the other country) and the New Zealand property was previously their main home by time spent, the exemption would (and should) apply.

If this is not the intended outcome, Officials should be asked to explain why not, and the Bill will need to be amended accordingly.

Submission 4

We submit that the requirement should be that the principal settlor of a trust does not own residential land that the settlor will be claiming the main home exemption in respect of (under section CB 16A) rather than simply "own[ing] a main home".

Comment

We support the ability for a trust (trustee) to avail itself of the main home exemption for residential land that is occupied by beneficiaries, if that land is sold within two years of acquisition. We note, however, that some of the requirements, such as the trustee needing to confirm that the principal settlor of the trust is not utilising the main home exemption may be problematic in practice (e.g. if the trustee is independent of the settlor).

The settlor may also wish to claim the main home exemption in respect of property owned by the trust, rather than other property the settlor may be residing in. At present the wording deems the main home exemption to apply to the settlor's other property, regardless of whether they wish for that property to be their main home.

Submission 5

We submit that ability to use the main home exemption for two properties sold at the same time should be legislatively prescribed.

Comment

We support the availability of the main home exemption for multiple properties, as outlined in the Bill commentary. However, the Bill as currently drafted does not explicitly say this. Instead, the main home exemption in proposed section CB 16A must be read in a particular way to achieve this outcome. Our concern is that in the absence of the stated policy intent in the Bill Commentary this outcome would not be apparent.

Given our concerns with reliance on statements in Tax Information Bulletins outlined earlier, we recommend that this rule be legislatively prescribed to provide maximum certainty.

Exemptions for inherited and relationship property (clauses 10 and 11)

Submission

We support the proposed exemptions from the bright-line test for residential land that is transferred on a person's death and on a settlement of relationship property.

However, we submit that there is no rationale for distinguishing between the tax treatments of subsequent sales of inherited and relationship property. The latter will be subject to the bright-line test, whereas the former will not.

Comment

The rationale provided by Officials, during consultation, 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 by the Committee.

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 (no clause)

Submission

We submit that holding costs (such as interest, insurance, rates, and repairs) should be deductible where residential land will be taxable under the bright-line test. The taxing event on sale creates the required nexus for the expenditure to be deductible. This should be explicitly clarified in the Bill.

At a minimum, there should be no presumption that holding costs are not deductible.

Comment

We are concerned with the view in the Bill Commentary that, notwithstanding a sale within two years being taxable under the bright-line test, holding costs may not be deductible if there is insufficient nexus with income and the private limitation applies. Officials view is that a 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. Otherwise the private limitation will limit deductions.

We note that holding costs in relation to holiday homes acquired for family use or bare land, for example, will not be deductible under such an approach, even if any gain on sale becomes taxable under the bright-line test. This is inequitable. We believe that such costs should be able to be treated as part of the cost of the property and deducted in the year of sale.

At a minimum, there should be no automatic presumption that holding costs are not deductible. Their treatment should be no different to the treatment of holding costs under the other land sale rules (e.g. section CB 6).

Ring-fencing rule for losses (clause 8)

Submission

We strongly disagree with the ring fencing of losses generated under the bright-line test and submit that this feature should be removed from the Bill.

Comment

There is no tax policy justification for ring-fencing losses when a gain from sale will always be taxable under the bright-line test. Loss ring fencing therefore effectively represents a one-way bet for Government.

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 tax rules generally) subsequently. It also illustrates our point that the bright-line rule will tax sales which ought not to be taxed, e.g. involuntary disposals in the bright-line period, which are also more likely to generate a loss.

Further, as the loss ring-fencing rule will not be applicable if the disposal is also taxable under one of the current land sale tax rules, this will create an incentive for taxpayers to argue that the residential land was acquired with the intention or purpose of resale to offset the loss. This creates uncertainty and incentives which are the reverse of the current position.

We understand that loss ring-fencing has been proposed to protect the revenue base. However, if 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 sale tax rules, there is potentially little fiscal benefit, but considerable complexity, from introducing a loss ring-fencing rule.

Land-rich companies and trust anti-avoidance rules (clause 14)

Submission

We submit that the proposed anti-avoidance rules (in proposed sections GB 52 and GB 53), for land rich companies and land rich trusts, are unnecessary. The Commissioner already has sufficient powers under the general anti-avoidance rule to challenge structures aimed at circumventing the bright-line test.

Comment

For the proposed anti-avoidance rules to apply, there must be a shareholding change (or change of trust arrangements) with the purpose or effect of defeating the bright-line test. The Bill Commentary states that determining whether such a purpose or effect exists will be under general anti-avoidance principles and case law. Therefore, the analysis will be identical to what is already required under the general anti-avoidance rule. We can see no compelling reason for specific anti-avoidance rules in these circumstances.

We are particularly concerned about how these rules will be applied in practice by Inland Revenue. For example, there is a risk that replacement of a trustee could trigger the anti-avoidance rule (being a change of trust decision maker). Replacement of trustees is common place. If this requirement is retained, we submit there should be an exemption for replacement of an independent trustee (such as one of the public trustees), as this will clearly not be done to circumvent the bright-line test. Alternatively, the specific 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.

Non-active trusts (clause 16)

Submission

We submit that the exclusion for non-active trusts from filing income tax returns needs to have a more reasonable income threshold (we suggest $500 of net income). As presently drafted, a trust cannot have any net income for the filing exclusion to apply.

Comment

The proposal in the Bill is to remove the current “nil” return requirement with a filing exemption for non-active trusts. The filing exclusion will only apply if the trust has no income or deductions other than certain minimal amounts. There is an allowance for reasonable fees paid to professional trustees and up to $50 of administration costs. However, allowable income is limited to bank interest and this cannot exceed the $50 of administration costs allowed. This means the net income of the trust must effectively be nil for the filing exemption to apply.

We consider there is no practical value from trusts having to file tax returns for minimal amounts – technically a single dollar of net income (i.e. $0.33 of tax) will trigger the need for a tax return. Compliance costs, and Inland Revenue's cost of processing returns, do not justify such an approach.

Further, we note that at the time of the non-filing changes for individuals in 1999, a $200 threshold (for income from which tax was either not deducted at source or incorrectly deducted) for requesting an income statement was introduced. We believe a similar filing threshold is justified for trusts (and other non-individual) taxpayers.

The $200 threshold has been unchanged for over 15 years. It is therefore timely for this to be increased to take into account inflation. We believe a $500 net income threshold (i.e. tax of $165), for both individual and non-individuals, is more reasonable.