

Tax Tips

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Introduction

The Government ruled out a capital gains tax in April. Since then, we have seen a considerable number of changes and proposals relating to the taxation of land.

This issue of Tax Tips outlines the activity around the land-taxing rules this year, including the introduction of the ring-fencing of residential rental losses in July. We also comment on Inland Revenue's guidance on the business premises exclusion and the tax treatment of short-stay accommodation as well as proposals on the regular pattern exemption, deductibility of holding costs for private use and tax on vacant land.

Background

In February 2019, the Tax Working Group (TWG) released its [final report](#) recommending a broad capital gains tax. The Labour-led Government could not reach consensus on the issue, ultimately abandoning the recommendation in April 2019. However, the TWG made 99 recommendations in total, and the Government has indicated that many of those recommendations will be considered. In the land context, the TWG recommended a vacant land tax, the repeal of the “10-year rule” under which gains from changes in land use are taxable, and the disclosure of a purchaser's IRD number when purchasing a main home. It expressly did not recommend a land tax.

Last year was a busy year for the land rules too. The residential bright-line test was extended to five years, where a taxpayer first acquired an interest in land on or after 29 March 2018. Outside the tax sphere, the foreign-buyer ban came into effect in October 2018, while loan-to-value ratio restrictions were eased in November 2018.

Looking forward to 2020, Inland Revenue's work programme includes looking at withholding taxes on land transactions and changes to enforcement in addition to the proposed changes in relation to regular pattern exemptions and the deductibility of holding costs.

Our expectation is that the Government will continue to tinker with the current land-taxing rules to ensure those rules are effective in collecting revenue from land transactions.





Tax Policy Work Programme

Changes to the land taxing rules are a prominent feature of the Government's current [Tax Policy Work Programme](#) (TPWP). Unsurprisingly, this includes a number of items arising from the recommendations contained in the TWG's final report to the Government. Specifically, the review will focus on investment properties, land-banking, vacant land, and speculation.

The Government has already progressed a number of these items:

TPWP item	Status
Improving the enforcement of existing land taxing rules, including the use of withholding taxes	No further announcements.
Clarifying and narrowing the deductibility of holding costs for revenue account property	Submissions closed 1 November 2019.
Reviewing the existing exclusions from the land rules, in particular the exceptions for developers and habitual renovators	Submissions closed 18 October 2019.
Reviewing the mixed-use asset GST apportionment rules	Expected to be included in GST issues paper, late 2019.
Information sharing with Land Information New Zealand (LINZ)	No further announcements.

In the longer term, the Government may consider:

- tax instruments to discourage land-banking and vacant land
- a review of the "10-year" land rules (which apply to those in the business of land dealing, land development, subdivision, or building)
- rules to improve the supply of land
- allowing losses on disposals of buildings, and
- reviewing the provisional tax rules for bright-line income from land sales.





New legislation ring-fences residential rental property losses

The [Taxation \(Annual Rates for 2019-2020, GST Offshore Supplier Registration, and Remedial Matters\) Act 2019](#) was enacted on 26 June 2019, bringing with it a suite of changes limiting a person's ability to offset losses from residential property investments against a person's other income (e.g. employment income).

The rules are effective from the beginning of the 2019/2020 income year. This means these rules will apply for the current income year and may result in more taxable income for those who have previously used their residential rental property losses to offset against their other income (e.g. employment income). Instead, residential rental property losses can only be used to offset against "residential income" earned in the year and any excess will be carried forward to the next income year.

We discuss some of the key features of the new rules below.

General application of the rules

The new rules apply to "residential rental property", with the term being defined as "residential land" as referenced in the bright-line test provisions. Therefore, farmland and land used as business premises are excluded.

There are also several types of property expressly excluded from the new rules, notably:

- the person's "main home"
- property held on revenue account
- property owned by Government enterprises or by companies other than close companies
- property that is subject to the mixed-use asset rules, and
- property provided to an employee for accommodation in connection with their employment (subject to special rules).

Residential rental income

A key feature of the new rules is that residential rental property losses can generally only be used against "residential rental income" derived in that income year. The new rules provide a comprehensive list of income that falls within the definition of "residential rental income". The types of income include:

- rental income
- depreciation recovery income
- any income from the sale of the property (if the land sales provisions apply), and
- rental income from property held on revenue account.

Portfolio vs property-by-property basis

The rules can apply on a property-by-property basis or a portfolio basis. The election is made by the person in the year the property becomes their residential rental property. If an election is not made at this time, the portfolio basis (as the default position) will apply for the life of the property.

If the portfolio basis is used, a taxpayer may use the deductions of one property against the income of any of the properties in the portfolio. Additionally, where all of the properties in a portfolio have been taxed on disposal (e.g. under the bright-line rules), any unused deductions existing after the disposal of the final property are no longer ring-fenced and can therefore be used to offset a person's other income.

If the property-by-property basis is elected, each property is looked at separately. Therefore, the excess deductions from one property cannot be used against the income from another property. Similar to the portfolio basis, if the person has taxable income from the disposal of the residential property, any excess residential property losses that the property has accrued can be used to offset against other income of the person for that income year.

Use of entities to hold property

Where a "residential land-rich entity" such as a company or a partnership is used to hold residential rental property, and debt is used to acquire an interest in that entity, the amount of the deduction that a taxpayer can obtain for interest expenditure is limited to the amount of rental income derived by the properties owned by the entity. A "residential land-rich entity" is defined as being:

- a close company, partnership, or look-through company if more than 50% of its assets by value are residential land, or
- a trustee of a trust whose property includes residential rental property if more than 50% of the trust's assets by value are residential land.

A key point to note is that "residential land" includes the main home. Therefore, if the main home is held by the entity, its value contributes to the 50% asset-value threshold.

Any close company intending to carry forward excess deductions to offset against rental income or income from the disposal of residential property in future income tax years must meet the shareholder continuity requirement for carrying forward company losses (i.e. 49%). Close companies that are part of a wholly-owned group may also transfer excess deductions between other property-holding close companies in the group.

General

Owners of residential rental properties need to understand the impact of the new rules on their tax liability for the 2019/2020 income year, including any impact to their provisional tax obligations.

Please get in touch with your usual PwC adviser if you would like to discuss the potential impact of these rules.

Business premises exclusion

Inland Revenue recently issued final guidance on the business premises exclusion that applies in relation to the land-taxing provisions.

The guidance considers the application of the business premises exemption to several land-taxing provisions of the Income Tax Act 2007, including sections CB 9 to 11. Generally, these sections will apply and tax the gains on the disposal of land where:

- the landowner or an associated person carries on a business of developing or dealing in land, or a building business, even where the land was not acquired for the purposes of that business; and
- the land is sold within 10 years of acquisition (or within 10 years of making improvements on the land, in the case of a building business).

The business premises exclusion (section CB 19) prevents the land-taxing provisions from applying i.e. to the extent the exclusion applies, any gain is not taxable. This exclusion is of particular importance for businesses that are associated with a developer, land dealer, or builder.

The initial draft of the guidance indicated that bare land could not be treated as business premises. Rather, “business premises” required there to be some building on the land. The draft also suggested that while the term “business premises” could encompass bare land around a building that was reserved for the use of the relevant business, this bare land had to be physically connected to the business premises to benefit from the exclusion. In our view, both of the propositions were not appropriate.

Specifically, in our view, business premises should benefit from the exclusion, even if the land has no building on it. A simple example is a quarry where there may be significant business operations on the land without the presence of any buildings. In this case, the business premises exclusion should apply, and a quarry sold within 10 years of acquisition should not be subject to tax by virtue of the land owner being associated with a developer or land dealer.

Similarly, we disagreed that the exclusion should only apply to bare land reserved for business use that is physically connected to or adjoining the business premises. For example, on the approach of Inland Revenue’s initial draft, if a carpark for a business premises was not immediately connected to the business premises, it would not have benefited from the exclusion. In our view, there are no policy grounds to justify this interpretation.

We were pleased to see that Inland Revenue took onboard many of our comments and other public submissions on the various iterations of the draft guidance, including accepting the possibility that bare land could constitute business premises, and that land reserved with business premises would not need to be connected to those premises.

However, we are disappointed that Inland Revenue did not address other concerns we had raised in the final guidance. One such example was clarifying whether the scope of the business premises exclusion includes situations where the business premises are leased to and occupied by a company in the same corporate group as the landowner and it is this other group company that carries on the relevant business. It is not uncommon in a group structure to have a property holding and business operations administered through separate group entities.

Another area where further clarity is required is whether farms would constitute as business premises. We also commented that the term “occupy” should not require exclusive possession and that leased property should be able to constitute business premises in circumstances where the lessor maintains some physical presence on the land in the course of carrying on its business.

The application of the business premise exclusion can still be tricky in some circumstances. Please contact your usual PwC adviser if this is relevant to your business.



Habitual buying and selling of land

In September, Inland Revenue released the tax policy consultation document [Habitual buying and selling of land](#) for consultation.

The land-taxing rules are generally aimed at bringing into tax disposals of land that occur as part of a profit-making scheme. There are various exclusions to recognise that some disposals are not in fact made as part of a profit-making scheme. These include the business premises exclusion and the residential home exclusion.

The habitual buying and selling proviso acknowledges that the residential land and business premises exclusions are potentially too broad, leaving open the possibility for taxpayers who are engaged in profit-making schemes to structure themselves into these exclusions. This proviso operates to prevent access to these exclusions where taxpayers have engaged in a pattern of buying and selling land. Understood in this way, for the purposes of the land-taxing provisions, a pattern of buying and selling land is taken as indicating a profit motive.

The consultation paper appears to acknowledge this: “While officials consider that the regular pattern restrictions require amendment to ensure that taxpayers cannot structure around them, it is not intended that such amendments should result in ordinary commercial or family transactions, where there is no purpose of sale, being taxed.” The draft specifically states that the regular pattern restriction should not apply, for example, to prevent small businesses moving to larger premises over time as they expand.

However, in our experience, Inland Revenue investigators in practice do not always appreciate that, for a disposal to be taxable, there is still the requirement of having acquired land with the purpose or the intention of disposal. For example, even where multiple sales have occurred over a period of time, and these sales are each explicable by reference to personal circumstances as to why the person had to move (i.e. the taxpayer did not have a profit-making motive) investigators have continued to insist that the pattern of multiple sales is evidence of an intention of resale. We were concerned that the proposal to relax the ‘similar activities’ interpretation will exacerbate these issues significantly.

In our view, any law change should be accompanied by commentary and guidance (including examples) that a person will not be treated as having an intention of resale based solely on a pattern of acquisition and disposal where there is a sound evidentiary basis that the disposal occurred for reasons other than the purpose of sale.

‘Group of persons or entities’ concept

The consultation paper proposes that a “group of persons or entities” concept will be introduced to the main home, residential, and business premise exclusions. This would mean the group will be considered as a single taxpayer when determining the application of the exclusions if that group occupied the land as their main home, residence, or business premise.

One of the key issues we identified with Inland Revenue’s guidance on the application of the business premise exclusion was the requirement that the land must be used by the landowner for the exclusion to apply. For example, it is common commercial practice for land to be owned by a holding company within a group and then for that land to be leased to another company within the group to carry out the business operations. Under the current guidance, the business premise exclusion would not apply when the land is sold.

In our view, it would be unfair to introduce this “group of persons or entities” concept to limit the scope of the exclusions but not extend the same concept to the general application of the exclusions. The current review is an appropriate time to consider an extension of, and the introduction of the group concept into, the various exclusions to the land taxing provisions.

Main home exclusion

The main home exclusion contains an additional restriction where the main home exclusion has been used twice in two years. The consultation paper proposes to extend this time-based restriction to the residential and business premises exclusion. The paper also proposes to extend the time restriction to twice in three years.

As a matter of principle, we disagree with any fixed time restriction on the basis that it is an arbitrary limit to the underlying rules and might apply to cause disposals to be subject to tax whether the disposals are not part of any profit-making undertaking. However, given that a time-based restriction already applies to the main home exclusion, we understand that it would at least be consistent with this position if a time-based restriction was included in relation to the residential exclusion.

However, it is our strong view that a time-based restriction should not be included in the business premises exclusion. To include such a restriction will cause disposals that are made for genuine commercial reasons to be subject to tax, even where the disposals are not part of any profit-making undertaking. It is reasonable to expect that the existence of this time-based restriction, and the potential for such tax, would have a distortionary effect on taxpayer behaviour, and cause what would otherwise be genuine commercial transactions to be delayed or not entered into at all.



Holding costs for privately used land that is deductible on sale

Holding costs are costs arising from land ownership (e.g. interest, rates, insurance, maintenance). Generally, the New Zealand tax system allows deductions where expenditure is incurred to generate taxable income, and disallows deductions where expenditure is private in nature. Where land is used solely for income-generating or private use, the law is clear on the deductibility of holding costs. However, where land is subject to tax on disposal (e.g. under the bright-line test), but was used privately while being held, the tax treatment of holding costs are unclear.

To clarify this, Inland Revenue is consulting on the tax treatment of holding costs for privately used land that is taxable on sale.

What is being proposed?

For private use periods, Inland Revenue has proposed 3 options:

1. Apportionment

Holding costs are apportioned between private-use benefits and the taxable gain on sale. This is the most accurate approach for determining the level of deduction allowed. However, the private benefit of current-year use needs to be measurable, and the taxable gains will not be known until the property is sold. There was a comment that a simplified apportionment approach be applied, whereby half of the holding costs are deductible for periods of private use. However, Inland Revenue is not in favour of any apportionment approach as it might be arbitrary, compromise accuracy, and increase complexity.

2. Allow all deductions

Full deductions are allowed for holding costs despite any private use. Deductibility is then based on whether there is a taxable use of the land (and not whether there is a private use of land). Inland Revenue is not in favour of this option as it is inconsistent with the principle of disallowing private expenditure.

3. Deny all deductions

Deductions for all holding costs are disallowed for periods where land is used privately. Deductibility will be based on the current-year use of land. Where there is mixed (income-earning and private) use of land, deductions would be denied only for the days where the land is used privately. This is Inland Revenue's preferred option as it is consistent with keeping private expenditure out of the tax base.

On the tax treatment of vacancy periods, two options are under consideration:

1. Partly vacant land:

Deductions are allowed based on the other uses of land during the period of ownership:

- where the land is actively used for either income-earning or private purposes, any vacant periods are treated similarly.
- where land is used for both income-earning and private purposes, and the vacant period is more than 62 days, the current 'mixed-use asset rules' could continue to apply. These rules apportion vacant days based on the proportion of actual private to income-earning days.

2. Wholly vacant/unused land

Deductions are allowed based on the intention or purpose for which the land is held:

- where land is held for a business dealing in, building on, or developing land;
- where land is held for an income-earning purpose (e.g. land bought to erect rental properties); and
- where the taxpayer at the time of purchase informs Inland Revenue that the land was acquired solely with the intention of resale for profit.

In essence, deductions are allowed where land is held with an income-earning intention or purpose. In all other situations where land is wholly vacant, the use of land would be considered private.



Tax on vacant land

The TWG also recommended that the Productivity Commission consider the effects and suitability of a vacant residential land tax as part of its inquiry into local government funding. As a result, the Minister of Finance asked the Commission for advice to be included in the final [Local Government Funding and Financing report](#).

The Commission’s draft report solicited submissions on a vacant land tax. A number of submissions came from local authorities. Some submissions supported a tax which would incentivise the efficient use of resources and indirectly reduce the cost of housing. The need to establish a clear definition and scope of “vacant land” and “unoccupied property” was a common submission. However, there were also significant economic and administrative concerns. Land supply is a complex issue and landowners withholding land from development is unlikely to be the primary cause.

The Commission released its final report on 12 December 2019. It notes that a vacant land tax has some appeal because it directly addresses the inefficiencies and inequities arising from land banking. However, on balance, the Commission concluded that a vacant land tax would be subject to definitional problems, have high administration costs, and be an ineffective instrument for improving the supply of available housing. In the long term, it could reduce housing-supply responsiveness by reducing developer flexibility and risk-taking. Other approaches to improving housing supply would be preferable. The Government will respond to the report in 2020.





Income tax and GST treatment of short-stay accommodation

Inland Revenue has recently released a series of draft guidance on the income tax and GST consequences of providing short-stay accommodation through peer-to-peer rental websites (such as Airbnb, Bookabach, or Holiday Houses). The draft guidance follows the finalised Questions We've Been Asked (QWBA) QB 19/05 to 19/09 which provide general guidance on the tax obligations for those supplying short-stay accommodation.

Property rented out by a beneficiary

The draft QWBA outlines how the income tax rules apply if a property held by a trust is rented out by a beneficiary of the trust for short-stay accommodation.

The draft guidance states that, where a beneficiary rents out all or part of the property for short-stay accommodation, the income is deemed to have been derived by the beneficiary. Non-capital costs related to the earning of income can be deducted, though some of these costs will only be partly deductible as they also relate to the private use of the property.

Property rented out by the trustees

This draft QWBA outlines how the income tax rules apply if a property held by a trust is rented out by the trustees for short-stay accommodation.

The draft guidance states that, where trustees rent out all or part of a property for short-stay accommodation, the income is deemed to have been derived by the trustees, and therefore generally will be included in the trust's tax return. However, some or all of the rental income may be allocated as beneficiary income, which would mean it is taxed at the beneficiary's tax rate. The draft QWBA also outlines the income tax treatment of beneficiaries paying expenses that the trust incurs in providing short-stay accommodation.

GST treatment of short-stay accommodation

A recently released draft Interpretation Statement (IS) outlines the Commissioner's view on the GST consequences of providing short-stay accommodation. This can be complex given the potential that short-stay accommodation may have both taxable and private non-taxable elements e.g. a host renting out a room or part of their home. "Short-stay" accommodation as defined in the draft IS includes accommodation that is provided for a period of less than four weeks and is not the guest's main residence during the period in question.

The statement sets out several scenarios in which a host would be considered to have a taxable activity, and therefore able to register for GST (or be required to register if their annual turnover exceeds the \$60,000 threshold).

Some of the issues considered by the statement include:

- **Input tax apportionment and ongoing adjustments:** input tax deductions can be claimed in respect of costs incurred by short-stay accommodation providers only to the extent that they are used (or available to be used) for making taxable supplies. The statement sets out a number of methods that the Commissioner accepts as a fair and reasonable estimate of the use of a property for making taxable supplies (i.e. providing short-stay accommodation) and its non-taxable use. Generally, this would be on a time and space basis i.e. the number of days it is provided as short-stay accommodation and/or the area of the property provided as short-stay accommodation. Once an apportionment has been made on this basis, ongoing adjustments are required periodically to account for any difference between the intended use of the property and the actual use.
- **Mixed-used asset rules:** special rules apply to properties that are used both privately and also to earn income, and are also unused some of the time (at least 62 days of the year e.g. holiday homes). These rules ignore the days when the property is being unused in order to determine the input tax apportionment and ongoing adjustments.
- **Disposal of the property:** the draft IS concludes that if any part of a property is used for providing short-stay accommodation, there is no apportionment of the output tax payable on the sale proceeds, although input tax not already claimed on the property is available to offset the output tax. However, in most cases this credit will not be enough to offset the output tax payable because the property is likely to have increased in value. While we agree this is the correct technical position based on the current law, in our view, this is a harsh and unintended policy outcome.
- **Deemed disposals:** hosts may decide at some point to cease their taxable activity of providing short-stay accommodation. If GST registered, the host will have to consider the GST implications of this, as they will be required to deregister for GST, and a GST output tax liability will arise in respect of the open market value of the property.

We generally agree with the Commissioner's analysis and conclusions, and the draft statement is helpful guidance. However, small variations in a host's particular circumstances could result in a different GST treatment than that which is set out in the statement's examples. We recommend reaching out to your usual PwC adviser if you are uncertain as to how the GST rules apply to you.



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