The Treasury

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Release Document

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Inland Revenue
Te Tari Taake

POLICY ADVICE DIVISION

PAD report: The acquisition date of land

Date:	7 December 2012	**Priority:**	Medium
Security level:		**Report no:**	PAD2012/266

Action sought

	Action sought	Deadline
Minister of Revenue	**Agree** to the recommendations and refer this report to the Minister of Finance and the Attorney-General.	14 December 2012

Contact for telephone discussion (if required)

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7 December 2012

Minister of Revenue

The acquisition date of land

Executive summary

A key element of an efficient tax system is certainty. That is, a person's liability for tax should be as clear and as certain as possible, especially in New Zealand where the tax system is based on self-assessment. This report focuses on the taxation of land disposal provisions in the Income Tax Act 2007, in particular section CB 6, which is causing considerable uncertainty for taxpayers, their agents and Inland Revenue.

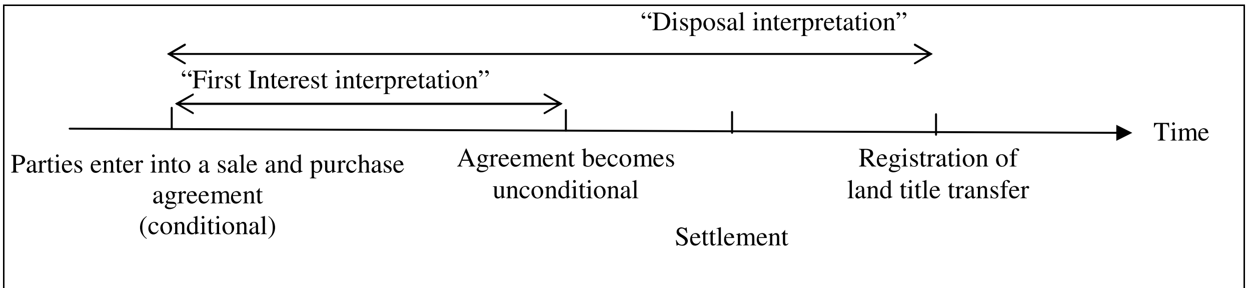
Section CB 6 deals with land acquired for the purpose or with the intention of disposal, and the taxation of income derived from disposing of the land. If a taxpayer acquires the land with the intention or purpose of disposal and subsequently disposes of the land, any profit they make from the disposal is taxable.

The uncertainty is caused by the timing of when the taxpayer's intention or purpose should be determined. The Courts have held that intention or purpose should be tested when a taxpayer has acquired the land in question (known as the date of acquisition). However because the definition of "land" in the Income Tax Act 2007 includes estates and interests in land, and the taxpayer acquires different interests and estates in "land" during a typical sale and purchase agreement, which are then merged when the title is registered, neither the legislation nor common law have provided sufficient clarity as to which "land" the date of acquisition should apply to.

In the absence of any government action or judicial clarity, taxpayers may be unable to self-assess whether gains made from a disposal of land should be returned as income. Often taxpayers are only made aware of a tax liability as a result of an Inland Revenue audit. On a practical level, this uncertainty places both Inland Revenue and taxpayers in a difficult position.

[7]

These interpretations have sometimes resulted in different tax consequences and there are potentially two possible dates of acquisition in each interpretation, as shown in the following diagram.



Phases of a sale and purchase agreement

[7]

This is exacerbated by the fact that agreements for the sale and purchase of land may occur over a span of months or years, and interests in land can be assigned or disposed of to another person before the title transfer is even registered.

From a tax policy perspective, the "first interest" interpretation, whereby the intention or purpose of the taxpayer is tested on the date the first interest arises in a sale and purchase agreement, is the preferred interpretation as it results in greater certainty and is more economically efficient.

This report therefore seeks your agreement to drafting and releasing an officials' issues paper to discuss the possible acquisition dates identified as a result of applying the preferred tax policy interpretation.

The issues paper will:

- discuss the reasons for the "first interest" interpretation being preferred over the "disposal" interpretation;
- outline the arguments for and against the two possible phases that the date of acquisition could be set at in the first interest interpretation (either when the agreement is entered into, or the agreement becomes unconditional and the purchaser can seek enforcement of the agreement) and seek submissions on these dates; and
- discuss whether further guidance is needed in respect to evidential issues that may arise due to the date of acquisition falling at the earlier phases of a sale and purchase agreement.

It is acknowledged that if the Government chooses to clarify the date of acquisition, taxpayers will have the opportunity to alter their behaviour under either interpretation to avoid having an intention or purpose of resale, or may capture some taxpayers whom the policy is not intended for. However, this risk exists currently [7]

At this stage, it is expected that a paper will be sent to Cabinet in late January 2013 to seek its approval to release the document. If Cabinet agrees, we will report back to you in March 2013 on the submissions and our recommendations, with a view to providing legislative amendments for inclusion in a tax bill in late 2013.

For ease of administration and in the interests of fairness, if the Government does agree to clarify the date of acquisition, we will recommend that any date of application be prospective, from the date of assent.

Any legislative amendment will not raise any revenue or system implications. There may be some minor administration implications, for example providing information to taxpayers on any proposed changes.

Recommended action

We recommend that you:

(a) **Note** that the application of the date of acquisition in section CB 6 of the Income Tax Act 2007 causes considerable uncertainty for taxpayers, their agents, tax practitioners and Inland Revenue.

Noted

(b) **Agree** that the first interest interpretation, whereby the intention or purpose of the taxpayer is tested on the date the first interest arises in a sale and purchase agreement, is from a tax policy perspective the preferred approach as it results in greater certainty and is more economically efficient.

Noted

(c) **Agree** to officials drafting a consultation document on the interpretation of section CB 6, with a view to providing legislative clarity in a taxation bill in late 2013.

Agree/Not agreed

(d) **Note** that any legislative clarification to section CB 6 will apply to all the land provisions in the Income Tax Act 2007.

Noted

(e) **Refer** a copy of this report to the Minister of Finance and the Attorney-General for their information.

Referred

Mike Nutsford
Policy Manager
Policy Advice Division

Hon Peter Dunne
Minister of Revenue

Background

1. Subpart CB of the Income Tax Act 2007 contains provisions that deal with the taxation of income from the disposal of land. In particular, section CB 6 deals with land acquired for the purpose of or with the intention of disposal, and the taxation of income derived from the disposing of the land. Therefore if a taxpayer[1] acquires the land with the intention or purpose of disposal and subsequently disposes of the land, any profit they make from the disposal is taxable.

2. The legislative history of section CB 6 is lengthy, as the profits made from the sale or disposition of real property were first deemed to be a source of "business income" in the Land and Income Assessment Act 1891.

3. The policy intent of this section is to capture property speculators, who can be described as persons who buy and sell land with the intent or purpose of making a profit without necessarily developing or improving the land, and relying instead on chance, trend or volatility of the property market to provide financial gain.

4. This was clarified in Hansard when the Land and Income Assessment Act 1908 was amended by the Land and Income Assessment Amendment Act 1912:

> *This is not an alteration in the law, but for the purpose of making the present Act clearer. Persons who speculate in land are liable to assessment for income tax on the profits from buying and selling the land.*

5. The key distinction between section CB 6 and a capital gains tax are the subjective elements, as the tax burden only falls on those who have the necessary intention or purpose to use land as if it were a trading asset. In this way the section attempts to distinguish between those who hold land as a capital asset and those who hold it as a revenue item. The economic rationale being, that if a person is able to make gains from buying and selling land without being taxed on these gains, it would inefficiently divert work effort away from taxable activities towards this task.

6. This report focuses on section CB 6 however the date of acquisition affects most of the land provisions in subpart CB. Therefore clarifying the date of acquisition will not only benefit section CB 6 but will increase the certainty in relation to most of the land taxing provisions in the following ways:

- CB 7 and CB 15: clarifies when land is acquired for purposes relating to land by associated persons.

[1] Note for the purposes of this report, the reference to the "taxpayer", is also a reference to the "purchaser" in the sale and purchase agreement for land. However the term "taxpayer" is used because if there has been a change of intention or purpose during the sale and purchase agreement and the purchaser decides to dispose of their interest in land, the "purchaser" then becomes a "vendor" for the second agreement. Therefore to avoid confusion between the agreements, the term "taxpayer" is used.

- CB 9, CB 10, and CB 14: clarifies when the 10 year period begins for a business dealing in land (including land development, subdivisions, and change of land under the Resource Management Act 1991).
- CB 18 and CB 19: clarifies when land is acquired for the purposes of the residential and business exemption.

The problem: applying different dates of acquisition

7. The uncertainty this reports seeks to address is caused by the timing of when the taxpayer's intention or purpose should be tested. The Courts have held that intention or purpose should be tested when a taxpayer has acquired the land in question (known as the date of acquisition). However because the definition of "land" in the Income Tax Act 2007 includes estates and interests in land, and the taxpayer acquires different interests and estates in "land" during a typical sale and purchase agreement which are then merged when the title is registered, neither the legislation nor common law have provided sufficient clarity as to which "land" the date of acquisition should apply to.

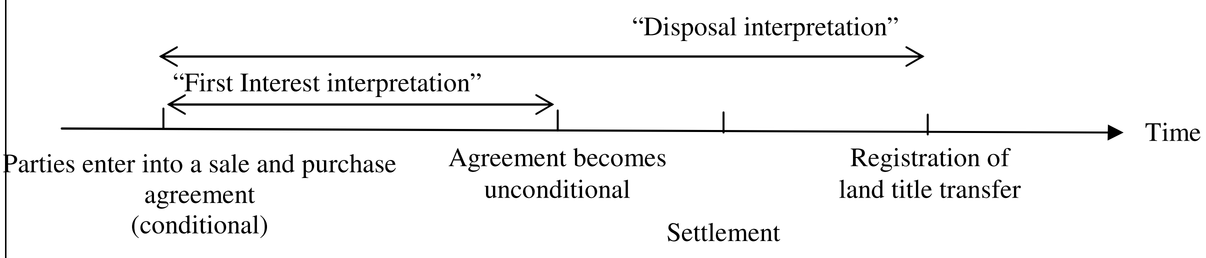
8. [7] the date of acquisition is the date when the first interest in land arises under an agreement for the sale and purchase of land (the "first interest" interpretation). The date of acquisition would therefore fall in one of the initial phases of a sale and purchase agreement, either:

- the date the agreement was entered into (even if the agreement was still conditional); or
- the date when all the conditions of the contract had been fulfilled (that is, when the agreement becomes unconditional).

9. A different interpretation [7] whereby the date of acquisition is determined by the "nature of the land" that is being disposed of (the "disposal" interpretation). Here, the date of acquisition would fall on the date the interest or estate is disposed of, which can occur at any point in the agreement, but is more than likely to be the later phases of a sale and purchase agreement that is either settlement or registration or in the alternative the date the agreement goes unconditional. By way of example:

- If the taxpayer disposes of a legal fee simple estate, the land is acquired when the legal fee simple estate (that is the title transfer) is registered by the Registrar-General of Lands under the Land Transfer Act 1952, as it is only at this time that the taxpayer is able to deal with the land in an absolute sense and is able to dispose of the land, or alternatively create new interests in land.
- If the taxpayer disposes of a lesser interest, for example a legal easement, the date of acquisition is when the legal fee simple is acquired. As per above, this date is when the land title is registered.

10. The following diagram illustrates and explains the different phases of a typical sale and purchase agreement.



Phases of a sale and purchase agreement

The basic four phases of a sale and purchase agreement are:

Conditional agreement – when the contract is entered into, an equitable interest is created in favour of the purchaser: specific performance in the wide sense (injunction or otherwise) is available to prevent the vendor dealing with the property inconsistently with the contract.

Unconditional agreement – with the exception of the payment of the purchase price, any conditions of the agreement (such as finance, solicitor's checks and other findings, building report LIM reports) have been fulfilled: the equitable remedy of specific performance (i.e. an order requiring the transfer of title) is available to the purchaser.

Settlement – purchaser either pays, gives or makes available the purchase price to the vendor and there is a conveyance of the clear and unencumbered title to the purchaser.

Registration of title – documentation evidencing the purchaser's right to the legal estate is registered under the Land Transfer Act, an act conferred by the State; the legal estate in fee simple is acquired by the purchaser.

Note:

- The time periods between the phases may vary.
- Where an agreement is subject to "true conditions precedent", a binding agreement will not be formed until the conditions are satisfied. An agreement that contains a condition subsequent is a binding contract.

11. [7]

taxpayer uncertainty regarding which date to apply to their land transaction(s) and, in some cases, unintended tax outcomes. This is exacerbated by the fact that agreements for the sale and purchase of land may occur over a span of months or years, and interests in land can be assigned to another person before the purchaser's name is registered on the title.

12. The following example shows how the tax outcomes may differ depending on the interpretation that is applied by Inland Revenue.

Example A

Tom and Sally are nearing retired. They decide to sell their Christchurch house and retire in Tauranga. They buy a house off the plans in a new subdivision in Tauranga and enter into a sale and purchase agreement with the developer Peter. The sale and purchase agreement for the Tauranga house is conditional on their Christchurch house being sold and the Tauranga house being completed.

Six months later, Tom and Sally enter into a sale and purchase agreement for their Christchurch house, this agreement is conditional on the Christchurch buyer receiving finance. Shortly after, the Christchurch buyer receives finance, and the Tauranga house is completed. However, before settlement of the Tauranga house occurs, Tom is diagnosed with cancer. Tom and Sally re-evaluate their circumstances and decide to move to Wellington for Tom's treatment and to be closer to family members. Tom and Sally re-advertise the Tauranga house through the developer Peter in the hope of finding a buyer.

Fortunately, Tom and Sally are approached by Rachael, who is keen to buy a house in the new Tauranga subdivision. Rachael enters into an agreement with Tom and Sally to purchase the Tauranga house as soon as the title is transferred from Peter. Tom and Sally stand to make a $5,000 profit, due to increasing property values and high demand in the Tauranga area.

Settlement of the Tauranga house occurs and the title is simultaneously transferred and registered from Peter, to Tom and Sally, and then to Rachael.

Potential tax treatment under "disposal" interpretation

The land disposed of is the legal estate in fee simple. This interest is acquired when the title transfer is registered from Peter to Tom and Sally. Tom and Sally's intention or purpose on this date is to dispose of the Tauranga house to Rachael therefore the $5,000 profit will be subject to tax.

Potential tax treatment under "first interest" interpretation

Tom, Sally and Peter did not have any conditions precedent in their sale and purchase agreement that intended for the parties not to be bound by the contract, once it was entered into. Therefore, under this interpretation an equitable interest has arisen in favour of Tom and Sally on the date they entered into the sale and purchase agreement for the Tauranga property. Tom and Sally's intention or purpose on this date was to live out their retirement in the Tauranga property. Therefore, their $5,000 profit will not be subject to tax.

Preferred interpretation from a tax policy perspective

13. A fundamental consideration of a coherent, broad-base, low-rate tax system is that taxes should be efficient through minimising distortions and impediments to economic growth. This "efficiency" consideration also needs to be weighed against the opportunity for tax planning and providing a sustainable revenue base for the Government.

14. It is acknowledged that if the Government chooses to clarify the date of acquisition, taxpayers will have the opportunity to alter their behaviour under either interpretation to avoid having an intention or purpose of resale, or may capture some taxpayers whom the provision is not intended for. [7]

15. We consider that a "first interest" interpretation is the more appropriate interpretation from a tax policy perspective and results in greater certainty and economic efficiency than the "disposal" interpretation, for the following reasons.

Decision-making at phases of the sale and purchase agreement

16. As the initial policy intent of this section is to capture property speculators, arguably the most appropriate time to assess a taxpayer's intention and purpose should be when a person decides to enter into a sale and purchase agreement. It is the initial decision-making that informs how a person intends to use the property, and bearing in mind the policy intent, it would be unusual for a property speculator to enter into a sale and purchase agreement unless they thought it very likely or speculate that the purchase and its subsequent disposal would be profitable.

17. Generally speaking, there are no clear or additional decisions or actions made by the taxpayer at any other time in the agreement. For example, the fulfilment of the conditions in a sale and purchase agreement is usually achieved through other mechanisms and often by third parties (such as obtaining finance from a bank, or a LIM report from the local council). Arguably, at that time, the taxpayer's decision to purchase the property, for whatever reason, has already been made. However, being able to take third party information into account may assist in determining what the taxpayer's actual intention for the land was.

Increase in land value and certainty of tax liability

18. A person's intention regarding the land may change between the date the agreement was initially entered into and a subsequent date, such as the date of registration. This concern is illustrated in the example above, and a risk that currently exists. If the person's intention is to purchase the property for resale, a "first interest" interpretation means that it is clear from the outset that any subsequent increase in value will be taxable.

19. A “disposal” interpretation, on the other hand, means that a person must wait until a later date (for example, registration) to determine whether the land is revenue-account property (that is, there is an intention or purpose to dispose of the land). They must account for tax not only on asset appreciation going forward from the date of intention to sell, but also any increase in value in the past – between entering the contract and the date that the test applies. There could also be an argument that it should only be from the date the intention was changed.

20. A “first interest” interpretation therefore provides the taxpayer with certainty from the initial point of entering into the sale and purchase agreement, of what an estimated tax liability may be if they have the intention to subsequently dispose of the land. The “disposal” interpretation delays that certainty until a later date, which may be a number of months or years into the future.

Distortion of behaviour and the lock-in effect

21. As noted above, the choice of interpretation can also lead to behavioural distortions. Under the “disposal” interpretation, a person desiring certainty may delay entering into a sale and purchase agreement until the title is nearly ready, as intention would be determined on the date of registration. This could increase certainty but, in doing so, may influence the person’s behaviour if they otherwise would have entered into the agreement on an earlier date.

22. A further distortion that occurs under the “disposal” interpretation, and in the situation where land values are increasing, is that there is an incentive for the taxpayer to defer disposing of the land (the lock-in effect) until title is acquired. However, if land values are decreasing, there is an incentive for the taxpayer to dispose of the land before title is acquired, and to state that the land was acquired for the purpose of resale in order to claim a tax loss. Under the “first interest” interpretation, such distortions do not arise because the intention is determined at the earlier phases of the sale and purchase agreement.

Impact on property market

23. In addition, the disposal interpretation arguably produces an inefficient outcome for the property market. Consider, for example, the development of an apartment complex that will take a number of years to complete. The developer may not proceed with construction unless a number of the apartments have been pre-sold. If purchasers are unwilling to enter into an arrangement until a date closer to completion and registration, because they need certainty about their tax liability, the developer may lack sufficient capital (or means to secure capital) to proceed with the development. There may also be an incentive for the purchaser to require a lower price (operating as a risk margin) to compensate for the uncertainty.

Evidence of intention or purpose

24. One of the main difficulties associated with the date of acquisition being set at the earlier phases of a sale and purchase agreement is the issue of providing evidence of a person's subjective intention or purpose

25. Currently if the taxpayer disputes a Commissioner's assessment of their tax liability or vice versa, the statutory burden of proof requires the taxpayer to prove, on the balance of probabilities, that the Commissioner's assessment is wrong (that is the taxpayer had no intention or purpose to dispose of the land when they acquired the land), and if so, why and to what extent?

26. The practical issue is that if the date of acquisition is marked at the earlier phases of an agreement for the sale and purchase of land, both the taxpayer and the Commissioner may have little evidence to prove/disprove their/the taxpayer's intention, particularly. This is less of an issue if the date of acquisition falls at the later stages of a sale and purchase agreement.

27. This evidentiary issue does not impact on providing certainty in regards to the date of acquisition, but nevertheless it does present practical implications that may need to be examined further. Therefore the issues paper could also discuss whether more legislative guidance should be provided as to the factors that the Court should take into account. For example, moving from a purely subjective test of the taxpayer's intention and purpose, to a reasonable person's test, where the Court would take into account all the facts (both objective and subjective elements) before it and asks "what is the taxpayer's intention or purpose using all the reasonable information available to the Court?"

Preferred phase of the first interest interpretation

28. As noted above, under the preferred first interest interpretation the date of acquisition would fall in one of the initial phases of a sale and purchase agreement, either:

- the date the agreement was entered into (even if the agreement was still conditional); or
- the date when all the conditions of the contract had been fulfilled (that is, when the agreement becomes unconditional).

29. At this stage of the two dates identified above, we do not have a preference as to which phase the date of acquisition should be set at. We will outline the advantages and disadvantages of both dates in the issues paper and seek views on both of these dates.

Proposed solution and next steps

30. [8]

[8]

31. [7] this report seeks your agreement for officials to clarify the legislation. If you are agree, we will draft an officials' issues paper on when land is deemed to have been acquired for tax purposes.

32. At this stage, it is expected that a paper will be sent to Cabinet in late January 2013 to seek its approval to release the document. If Cabinet agrees, we will report back to you in the first half of 2013 on the submissions and our recommendations, with a view to providing legislative amendments for inclusion in a tax bill in late 2013.

Application date

33. For ease of administration and in the interests of fairness, if the Government does agree to clarify the date of acquisition, we will recommend that the application date be from the date of Royal assent.

Administration, revenue and systems implications

34. Any legislative amendment will not raise any revenue or system implications. There may be some minor administration implications, for example providing information to taxpayers on any proposed changes.

Impact on the Property Compliance Programme

35. In response to concerns regarding the taxation of property transactions, the Government allocated $14.6 million to Inland Revenue in 2007 to establish a specific property audit unit the Property Compliance Programme, focussed on enforcing and monitoring compliance in the property taxation area and to improve the level of compliance by specifically targeting property speculators and dealers in land. Due to their success, the Programme has received further funding to 2014.

36. If the legislation is clarified, the impact on this programme is likely to minor, if at all, as the legislation will apply only to new acquisition of land cases that occur from the date of application (most likely sometime in 2014), not current or old cases that the Programme will be dealing with.

Consultation

37. [8]

38. [8]

39. [8]

40. [8]

The Crown Law Office

41. The Crown Law Office has been consulted in the preparation of this report. [7]

we recommend you refer a copy of this report to the Attorney-General for his information.

The Treasury

42. The Treasury has been consulted in the preparation of this report, and we recommend you refer a copy of this report to the Minister of Finance.