

ARTICLE

The New Two-Year Income Tax Bright-line Rule

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The Taxation (Bright-line Test for Residential Land) Act 2015 was enacted on 16 November 2015. The Act inserts s CB 6A into the Income Tax Act 2007, requiring income tax to be paid on any gains from the sale of residential property that is bought and sold within two years. This article assesses this amendment to the Income Tax Act and concludes that the rule is undesirable. It is inconsistent with the rest of the Income Tax Act, unnecessarily complex and unlikely to achieve its intended effect of increasing compliance with the existing provisions.

I Introduction

Widespread concern regarding compliance with existing tax rules on property transactions resulted in the announcement of three changes to New Zealand's tax system as part of the 2015 Budget. The first two measures were fairly rudimentary and related to the information that taxpayers are required to provide when purchasing property in New Zealand.¹ The third change—the so-called “bright-line rule”—was decidedly more controversial.² That was to be expected. The rule is for all intents and purposes a *short-term capital gains tax*—despite comments by both the Labour Party³ and the National Party⁴ to the contrary.

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1 Land Transfer Amendment Act 2015.

2 For example, see Craig Elliffe “Bright-line test for house sales lacks lustre” *The New Zealand Herald* (online ed, Auckland, 6 July 2015).

3 Audrey Young and Lane Nichols “PM makes major move on housing profits and foreign buyers” *The New Zealand Herald* (online ed, Auckland, 17 May 2015).

4 John Roughan “Capital gains tax is here—why no fanfare?” *The New Zealand Herald* (online ed, Auckland, 23 July 2015).

The Taxation (Bright-line Test for Residential Land) Bill was introduced to Parliament on 24 August 2015,⁵ with the expectation that it would be in force by 1 October 2015. That date was quickly pushed back to 22 October 2015. The Bill was finally enacted on 16 November 2015. These delays speak to the controversial nature of the rule, as well as the difficulties in its design. The Taxation (Bright-Line Test for Residential Land) Act (the Act) inserts s CB 6A into the Income Tax Act 2007, requiring income tax be paid on any gains from the sale of residential property that is bought and sold within two years.⁶ The rule is subject to a number of exemptions, the most important of which is where the property is the seller's main home.⁷ Losses under the rule are ring-fenced⁸ and the final product includes a specific anti-avoidance provision.⁹ The rule promises to be significant: some people who have sold property in unexpected circumstances will now have to pay tax on the proceeds, regardless of whether or not they purchased the property with the intention of selling it. In this respect, the rule marks a significant departure from the current tax rules regarding property transactions in New Zealand.

The introduction of the bright-line rule was followed by the announcement of a residential withholding tax for overseas persons—the Taxation (Residential Land Withholding Tax, GST on Online Services, and Student Loans) Bill. The withholding tax is not considered in this article because that rule only affects overseas persons and the withholding obligation falls on lawyers, rather than the taxpayers concerned.

Part II considers the current provisions in the Income Tax Act that make some land-based transactions taxable. This is essential, for therein lies the problem that the bright-line rule seeks to solve. Part III considers the purpose of the bright-line rule and the objectives behind its design. This is followed, in Part IV, by an overview of the rule itself. The remainder of the article is devoted to a critique of the rule, and is split broadly into three discussions: inherent problems with the rule (in Part V), unnecessarily complex parts of the rule (in Part VI), and inconsistencies between the rule and the rest of the Income Tax Act (in Part VII).

I conclude that the rule is a welcome attempt to improve New Zealand's property tax rules. However, the rule will adversely affect a class of taxpayers that it does not target. Furthermore, it is inconsistent with the Income Tax Act as a whole and unnecessarily complex. These concerns need to be addressed if the rule is to be successful.

II The Statutory Status Quo

New Zealand does not have a specific or comprehensive capital gains tax (CGT). That is not to say that some capital gains are not taxed. Parliament has defined some capital gains as income and, therefore, made them taxable. Sections CB 6 to CB 23 of the Income Tax Act specifically bring within the definition of income—and make taxable—various classes of gains made on the disposal of land. The rules in these provisions are significant as they provide the statutory context within which the bright-line rule will

5 See Inland Revenue "Taxation (Bright-line Test for Residential Land) Bill" <www.taxpolicy.ird.govt.nz>.

6 Taxation (Bright-line Test for Residential Land) Act 2015, s 4.

7 Section 8.

8 Section 10.

9 Section 18.

operate. It is desirable that the bright-line rule remains consistent with these rules and the Income Tax Act more generally.¹⁰

The provisions in ss CB 6 to CB 23 fall broadly into four categories:¹¹

1. Land acquired for the purpose or with the intention of disposal;
2. Businesses using land;
3. Schemes for development and division; and
4. Land sold within 10 years of acquisition, where at least 20 per cent of profit was due to planning controls.

The most relevant provision for the purposes of this article is s CB 6. This provision deems that “[a]n amount that a person derives from disposing of land is income of the person if they acquired the land” for the purpose of, or with the intention of, disposing of it.¹²

Under s CB 6, it is irrelevant that the purpose of disposal is neither the sole purpose nor the dominant purpose of the taxpayer at the time of purchase. This section also lacks a time limit after which a purchase can no longer be seen as being made with the intention of resale. A taxpayer could thus hold a piece of property for 50 years and nonetheless be found to have bought it with the intention of resale.

Section CB 6 is subject to a number of exemptions. A taxpayer will be exempted if the land is occupied mainly as a residence—although that exemption will not apply if the taxpayer has engaged in a regular pattern of buying and selling land.¹³ A taxpayer will also be exempted if the land is used for business premises.¹⁴

In 1990 the High Court decided *Jurgens and Doyle v Commissioner of Inland Revenue* and established that the purpose or intention of the taxpayer under s CB 6 is “ascertained on a subjective basis”.¹⁵ This makes the test notoriously difficult to apply.¹⁶ Under s 149A(2) of the Tax Administration Act 1994, the burden of proof falls on the taxpayer, not the Commissioner.¹⁷ However, it is always open to the seller to argue that they did not purchase the property with the intention of selling it. While the purposes stated by the taxpayer will not necessarily be determinative, they “are obviously important evidence”.¹⁸

The subjective nature of the test means that no single factor will be conclusive of a taxpayer’s intention. In 2011, Inland Revenue released a statement detailing how a taxpayer’s intention when buying a property is ascertained.¹⁹ The factors assessed include, but are not limited to, the number of properties you have bought and sold over

10 Inland Revenue *Regulatory Impact Statement: Bright-line test for sales of residential property* (7 August 2015) [*Regulatory Impact Statement*] at 4.

11 Shelley Griffiths “The Game is Not Worth the Candle’: Exploring the Lack of a Comprehensive Capital Gains Tax in New Zealand” (2015) 21 NZJTL 51 at 58.

12 Income Tax Act 2007, s CB 6.

13 Section CB 16.

14 Section CB 19.

15 *Jurgens v Commissioner of Inland Revenue* (1990) 12 NZTC 7,074 (HC).

16 Michael Littlewood “The Tax Consequences of Withdrawals of Trading Stock: Resolving the Conundrum of *Sharkey v Wernher*” (2005) HKLJ 35(2) 327 at 339. “If a rule which solves the problem can be formulated without reference to the taxpayer’s state of mind, so much the better.”

17 Tax Administration Act 1994, s 149A(2).

18 *Commissioner of Inland Revenue v National Insurance Co of New Zealand Ltd* (1999) 19 NZTC 15,135 (CA) at [18].

19 Inland Revenue “Buying and selling residential property IR313” (December 2015) Inland Revenue <www.ird.govt.nz>.

a period of time, discussions with banks or real estate agents, council documentation, and actual or planned involvement in the community.²⁰

Problems with the application of s CB 6 have arisen in a number of cases.²¹ One example is *Commissioner of Inland Revenue v Boanas*.²² In that case the intention test resulted in the four taxpayers being cross-examined, whilst six professionals and advisers involved in the transaction were called upon to give evidence. The subjective nature of s CB 6—coupled with the fact that no single factor is conclusive of a taxpayer's intention—means that the provision is decidedly difficult to apply. The bright-line rule seeks to remedy this.

III The Purpose of the Rule and the Objectives Behind its Design

The purpose of this Part is two-fold. It first examines the general purpose of the bright-line rule. It then observes the specific objectives that officials had in mind when designing it. This is an important—and indeed necessary—preliminary to examining the rule itself, for it sets the standard against which success will be assessed.

A *The purpose of the bright-line rule*

The Bills Digest noted how a “bright-line rule (or bright-line test) is a clearly defined rule or standard, generally used in law, composed of objective factors, which leaves little or no room for varying interpretation”.²³ The purpose of such a rule is to “produce predictable and consistent results”.²⁴ As discussed later in the article, the intention test in s CB 6 can be difficult to enforce due to its subjectivity. The bright-line rule aims to resolve that issue by “supplementing the intention test with an unambiguous objective test”.²⁵

Upon announcement of the rule, the Prime Minister, John Key, emphasised that it is:²⁶

... aimed squarely at ensuring that property buyers—including overseas speculators—who buy residential property with the intention of selling for a gain pay their fair share of tax as required by the law.

The rule is specifically targeted at property speculators in residential areas. Rising house prices are of particular concern. In Auckland, for example, the median price rose by 17.7 per cent in the year to April.²⁷ That trend shows no sign of slowing down. Indeed,

20 At 11.

21 See generally *Plimmer v Commissioner of Inland Revenue* [1958] NZLR 147 (SC). The problem of intention dates back to this case.

22 *Commissioner of Inland Revenue v Boanas* (2008) 23 NZTC 22,046 (HC).

23 John McSorley *Taxation (Bright-line Test for Residential Land) Bill 2015* (Parliamentary Library, Bills Digest 2253, 7 September 2015).

24 (8 September 2015) 708 NZPD 6338.

25 Inland Revenue *Bright-line test for sales of residential property: An officials' issues paper* (June 2015) [*An officials' issues paper*] at 1.

26 Inland Revenue “Budget 2015—property compliance proposals announced” (17 May 2015) Inland Revenue <www.taxpolicy.ird.govt.nz>.

27 Brian Gaynor “Challenge to stop housing boom turning into bubble” *The New Zealand Herald* (online ed, Auckland, 16 May 2015).

recent reports place the rate at in excess of 20 per cent.²⁸ It is hoped that the bright-line rule will “take some of the heat out of [the] housing market”.²⁹

Increasing tax yield is not a stated goal of the bright-line rule, except insofar as the rule will catch those who should already be paying tax. Officials, admittedly conservatively, expect the two-year bright-line rule to raise an additional five million dollars per annum.³⁰ It follows then that considerations of tax yield should be subservient to the specific objectives outlined in the following section.

B The objectives in designing the rule

In terms of the specific design of the rule itself, officials had three objectives in mind. These were to:³¹

- a) Provide an easier rule for Inland Revenue to enforce to target short-term speculation in residential property.
- b) Minimise the number of sales made taxable that were acquired without an intention of resale.
- c) Minimise compliance costs for taxpayers in complying with the bright-line test.

These three objectives represent a simple framework for analysing the design of the rule and will be used as such in the following Parts of the article.

IV The Scope of the Rule

The general scope of the rule is reasonably clear. Income tax will now need to be paid on any gains from the sale of residential property that is bought and sold within two years, subject to a number of exemptions.³² It would appear from the way in which the rule was announced that it would be simple and easy to draft. That has not been the case. The final product comes with a number of additional features and this is partly causative of the delay in the rule’s enactment. The purpose of this Part is to provide an overview of those features.

A Date of acquisition and date of disposal

To be within the scope of s CB 6A, the property must be disposed of within two years of acquisition.³³ The date of acquisition is the latest date on which the person acquires an interest in land—in most cases, presumably, the date that the title is registered for the purchase. On the other hand, the date of disposal is the date that a person enters into a contract to sell the property.³⁴ This aspect of the bright-line rule will be discussed in

28 Belinda Feek “Auckland property further out of reach for homebuyers” *The New Zealand Herald* (online ed, Auckland, 17 September 2015).

29 Inland Revenue “Budget 2015—property compliance proposals announced”, above n 25.

30 Inland Revenue *Regulatory Impact Statement*, above n 10, at 5.

31 At 4.

32 Income Tax Act, s CB 6A.

33 Section CB 6A.

34 Section CB 6A. For transfers other than sale, the date of acquisition and date of disposal will be determined by other rules. Taxation (Bright-line Test for Residential Land) Act 2015, s 13.

detail later in the article insofar as it is inconsistent with the Income Tax Act as a whole and, therefore, undesirable. If the property falls outside the two-year period, it may nonetheless be taxable under s CB 6. In that case, the enquiry will revert back to the question of whether the taxpayer purchased the property with the intention of resale.

B Residential land

The second point of note is that the land must be residential. This fits with the objectives of the rule, which, as discussed earlier, partially target rising house prices. Residential land is defined as “land that has a dwelling on it”—or land for which there is an arrangement to build a dwelling on it—or bare land that, because of its area and nature, is capable of having a dwelling erected on it.³⁵ Residential land will not include land that is predominantly used as business premises or as farmland.³⁶ These two exemptions are consistent with the rest of the Income Tax Act. Section CB 19 provides that s CB 6 does not apply to land mainly used for business premises. Similarly, while s CB 6 does not generally exclude farmland, other land-sale provisions do.³⁷

C Exemptions

The Act includes three exemptions to the rule: a disposal of property that is the main home of the transferor; a disposal of inherited property; and a transfer under a relationship property agreement. These will be discussed in turn.

(1) Main home

A transferor will not be liable to pay tax under the bright-line rule if the property that is disposed of is their main home. This exemption is presumably to make the rule politically feasible. The sanctity of the family home in New Zealand is well-documented and reflected in the fact that historic attempts to introduce a comprehensive CGT have frequently exempted its taxation.³⁸ Owner-occupied residences are also exempt from capital gains regimes in Canada, Australia, the United Kingdom and the United States (although the latter has an exemption threshold).³⁹ Furthermore, the exemption is consistent with the Income Tax Act as a whole, as the land-sale rules generally exclude the sale of a person's main home.⁴⁰ While not exempting the family home would undoubtedly provide for a clearer objective test, officials have reasoned that property is also “less likely to have been bought with an intention of resale if it is the seller's main home”.⁴¹

35 Income Tax Act, s YA 1.

36 Section YA 1. The latter is defined as land “where the area and nature of the land disposed of means that it is then capable of being worked as an economic unit as a farming or agricultural business”. Inland Revenue *An officials' issues paper*, above n 25, at 4.

37 Income Tax Act, ss CB 12–14.

38 The family home was exempt from Labour's 2011 and 2014 CGT proposals. Andrew Maples “A Comprehensive Capital Gains Tax in New Zealand – No Longer Political Hari-Kari?: A Consideration of the Labour Party Proposal of 2011” (2014) 20 NZJTL 144 at 156.

39 Shaleshni Sharma and Howard Davey “Characteristics of a Preferred Capital Gains Tax Regime in New Zealand” (2015) 21 NZJTL 113 at 121.

40 Income Tax Act, s CB 16.

41 Inland Revenue *Regulatory Impact Statement*, above n 10, at 8.

For the purposes of the rule, a property will be the main home of the owner when it has been “mainly used as [their] residence”.⁴² If the owner of the property has two or more homes, then the main home will be the property with which they had the “greatest connection”.⁴³ As will be seen later in the article, this definition is not as simple as it may seem, although the number of cases where it will be an issue is likely to be minimal.

The Act also includes a relatively novel feature insofar as s 8 provides that a person cannot use the main home exemption if they have already used the exemption “[two] or more times within the [two] years immediately preceding the bright-line date [date of disposal] for the residential land”.⁴⁴ With respect, this represents an ad hoc addition to the rule, given that it was not included in the Issues Paper or the Regulatory Impact Statement.

The Act also incorporates a separate set of rules regarding the applicability of the main home exemption for property held by trusts. Whilst the main home exemption will apply when the property is owned by the trust and the dwelling is the main home of a beneficiary of the trust, the main home exemption will not apply to any property owned by the trust if the principal settlor of the trust has a main home that is not owned by the trust.⁴⁵

(2) Inherited property

The second exception is for inherited property. Where A dies, transferring their property to B, the latter will not have to pay tax if they sell the property within two years of acquisition.⁴⁶ The reason is that B had no intention of acquiring the property in the first place.

(3) Relationship property agreements

The third and final exemption is for transfers under a relationship property agreement—for instance, where A and B were married but subsequently divorce. If A receives property under a relationship property agreement, that transfer will not give rise to a tax liability under the bright-line rule.⁴⁷ Like the rule regarding inherited property, the reason is that A had no intention of acquiring the property in the first place.

D Deductions

If a property is taxable under s CB 6A, the taxpayer will be able to deduct expenditure under s DB 23.⁴⁸

42 Income Tax Act, s YA 1.

43 Section YA 1.

44 Taxation (Bright-line Test for Residential Land) Act, s 8. Note that *bright-line date* and *date of disposal* have the same meaning.

45 Section 8.

46 Income Tax Act, s FC 9(2).

47 Income Tax Act, s FB 3A.

48 Income Tax Act, s DB 18A(1).

E *Losses*

Another equally important tenet of the tax system is the ability to offset losses. As noted in the Issues Paper, “[e]nabling losses to be claimed in circumstances when gains are taxable ensures symmetry and avoids economic distortions”—it is *prima facie* the correct outcome.⁴⁹

What happens if property taxable under the bright-line rule is sold at a loss? For instance, say that A purchases an investment property for \$500,000 and sells it a year later for \$400,000. The sale is clearly taxable under the bright-line rule, but A has made a loss of \$100,000. Under s CB 6A, the seller will be able to claim this loss. However, the loss will be ring-fenced.⁵⁰ In other words, the seller will only be able to offset that loss against gains from other land sales. This is significant. Losses are not ring-fenced if they are taxable under another land sale rule. This inconsistency promises to give rise to a wave of problems and will be expanded upon later in the article.

F *Inflation*

Inflation is one of the main problems with the design of CGTs generally, although New Zealand and other jurisdictions tend not to make any *direct* allowance for it.⁵¹ The bright-line rule also makes no allowance for inflation. A simple example serves to illustrate this problem. Say that A purchases a house for \$500,000. Assuming that the rate of inflation is 2 per cent, if A sells the house a year later, they will receive \$510,000. A will be taxed at their marginal rate on \$10,000, even though this is solely the result of inflation. This is *prima facie* undesirable, because taxable gains from capital assets should be real not nominal. It is nonetheless consistent with the Income Tax Act as a whole, for the Act makes no allowance for inflation. In this instance, not making an allowance for inflation fits with the desire for a simple rule with as few exceptions as possible. Gains from inflation are likely to be minimal, in the current economic environment, over a two-year period.

V **Inherent Problems with the Rule**

The first point to be made is that a capital gains tax on real property is not necessarily a guaranteed solution for reducing housing prices.⁵² This article does not seek to engage in a discussion of that issue—in part because it has been recognised by the Government and in part because that question has already been examined elsewhere.⁵³ Rather, it seeks to show that the bright-line rule is inherently problematic on two further levels.

49 Inland Revenue *An officials' issues paper*, above n 25, at 27.

50 Income Tax Act, s DB 18(2).

51 United States and Canada do not offer indexation for inflation. Australia and the United Kingdom used to, but have now abolished it. See Sharma and Davey, above n 3939, at 120. Any allowance for inflation in these jurisdictions is through the blunt instrument of a lower rate of tax for capital gains.

52 At 124.

53 Inland Revenue *Regulatory Impact Statement*, above n 10, at 2. The Government acknowledges that “other possible causes, both on the supply and demand sides” are being considered.

The basic design of the bright-line rule means that it will be easy to apply in most circumstances. This is aided by the fact that other measures intended to operate in conjunction with the bright-line rule have now been enacted.⁵⁴ Put briefly, these changes require all non-residents and New Zealanders buying and selling property (other than their main home) to provide a New Zealand IRD number. Non-residents will also need to have a New Zealand bank account to get a New Zealand IRD number.

A Taxpayers who did not purchase property with the intention of resale

Ease of application does not come without a cost. From the outset, it is clear that the rule will impose income tax on persons who did not purchase the property with the intention of selling it. One of the objectives when designing the rule was to minimise this class of persons—hence the exemptions for inherited property and property transferred under a relationship property agreement. Submissions on the Bill nonetheless pointed out a number of situations where people will be taxed even though they did not have the requisite intention for disposal at the time of purchase.⁵⁵ These broadly fall into three categories: taxpayers whose personal situations have changed, where, for example, they have been forced to sell due an event, such as the Christchurch earthquake; taxpayers whose employment has changed, necessitating relocation; and taxpayers whose financial circumstances have changed, for instance through bankruptcy. It remains to be seen exactly how many taxpayers will fall into this class. If the number is significant—as one is inclined to suspect—then the bright-line rule will have failed in achieving one of its stated objectives.

It would, of course, be possible to make s CB 6A a rebuttable presumption. However, doing so would defeat the very purpose of having a bright-line rule in the first place. In this instance, it is submitted that the solution to the problem is reasonably self-evident. Whilst the new rules introduced with the Land Transfer Amendment Act 2015 make the bright-line rule easier to enforce, they also make the s CB 6 intention test easier to apply. This leads one to ask whether the bright-line rule is even necessary. The associated changes would arguably do the job that the bright-line rule does (and more), *without* imposing tax on people who bought and sold a property within two years without the intention of resale.

It is the author's view that it is advantageous to better enforce existing rules, rather than to spend money introducing and administering the bright-line rule.⁵⁶ This sentiment is echoed elsewhere. Indeed, a 2014 survey of tax professionals in New Zealand found that 27.5 per cent of tax professionals in New Zealand "preferred greater enforcement of existing provisions rather than an additional tax".⁵⁷

B An arbitrary cut off

Short-term capital gains taxes are not without historical precedent in New Zealand. The little-known Property Speculations Act 1973 made the proceeds of land acquired and

54 Land Transfer Amendment Act 2015.

55 See Inland Revenue *Regulatory Impact Statement*, above n 10, at 11.

56 See also Sharma and Davey, above n 39, at 124. A survey of tax professionals thought the existing rules needed to be better enforced.

57 At 134.

disposed of within two years taxable. A notable feature of that Act was that property was completely exempted from tax if it was held for more than two years.⁵⁸

The bright-line rule is not intended to apply like that, but it might nonetheless have that effect if it is not properly applied. The bright-line rule will most likely result in behavioural changes amongst taxpayers. This has already been seen with taxpayers taking advantage of the lack of retrospectivity of the Act by pre-emptively selling residential property before the bright-line rule comes into force.⁵⁹ Given that any sales of property within two years will be taxable, property speculators will simply retain property for more than two years.⁶⁰ This means that the rule might act as an arbitrary cut off, whereby any sales made after two years simply slip through the radar—even though the property was purchased with the intention of disposal. Careful vigilance will be required on the part of officials to ensure that sales made after two years do not escape liability to tax.

If the two-year period does act as an arbitrary cut off, then the rule may give rise to vertical inequity. Property speculators—who generally have the resources to hold on to property for more than two years—will be able to avoid paying tax, whilst those who have had to sell property within two years due to circumstances outside their control (most often those in lower socioeconomic classes) will have to pay tax on it.

C Conclusion

These two problems are inherent as a result of the rule being a *bright-line*. While the extent to which they occur in practice remains to be seen, they are unavoidable to some degree. By themselves, these inherent problems are likely enough to make the bright-line rule undesirable. The next two Parts of the article will focus on aspects of the design of the rule that *were* within the control of the drafters: consistency with the rest of the Income Tax Act; and simplicity.

VI Is the Rule Unnecessarily Complex?

Putting to one side the inherent problems with the rule, the specific details are also cause for concern. One of the objectives when designing the rule was to avoid unnecessary complexity. This Part of the article will argue that the final product is nonetheless unnecessarily complex. There are two aspects to this: first, the anti-avoidance provision; and, secondly, the main home exemption. These are addressed in turn.

A The anti-avoidance rule for land-rich companies

Without an avoidance rule, taxpayers would be able to escape the bright-line rule by “holding property in a company or trust and transferring control of the company or trust

58 Property Speculations Act 1973, s 15.

59 Anne Gibson and Nicholas Jones, “Buyers rush to beat Govt property change—agent” *The New Zealand Herald* (online ed, Auckland, 20 July 2015).

60 78 per cent of tax professionals thought that short term capital gains taxes are problematic because they “may attract certain boundary behaviours”. Sharma and Davey, above n 3939, at 128.

rather than selling the land itself".⁶¹ This is prima facie undesirable, for taxpayers should not be able to easily avoid liability to tax. Avoidance undermines the legitimacy and coherence of the tax system as a whole.

The Regulatory Impact Statement put forward two options to prevent avoidance. The first possibility was a specific anti-avoidance rule, such as those found in sub-pt GB of the Income Tax Act. This would increase the accuracy of the application of the rule, but would also serve to increase complexity and compliance costs.⁶² The second possibility was a general anti-avoidance rule. While this could create uncertainty, it would be less complex and easier to comply with.⁶³

Having balanced the relative merits of these two options, Parliament appears to have settled for the former—a specific anti-avoidance rule. The Act inserts s GB 52 into the Income Tax Act. The section will apply where a company owns residential land (directly or indirectly) and that land makes up 50 per cent or more—by value—of the assets of the company. In that case, if 50 per cent or more of the shares in the company are disposed of within a 12-month period with the purpose or effect of defeating the intention of defeating the bright-line test, the transaction will be caught by the anti-avoidance provision.

It is submitted that there is a third option that is, in fact, preferable: having no anti-avoidance rule whatsoever. As noted in the Regulatory Impact Statement, "it does not appear there are large numbers of people avoiding the land sale rules through the use of companies or trusts".⁶⁴ Given the scale of the problem, increasing the complexity of the bright-line rule by introducing an anti-avoidance provision plainly does not appear to be justified. An illustrative example is the treatment of land-rich companies in Hong Kong, where taxpayers are free to incorporate land into a company and sell the company so as to avoid liability to tax.⁶⁵ While a taxpayer would be able to avoid paying tax in such an arrangement, no anti-avoidance rule is needed for the simple fact that people generally do not favour purchasing land through a company. The risk of purchasing a company that may have undisclosed liabilities outweighs paying a potentially lower price.

While Parliament's intentions are understandable, it is submitted that the purpose of the bright-line rule would be better served by removing the specific avoidance rule.

B *Test for main home*

Exempting the main home is not without its difficulties. Officials will need to identify what, exactly, is a person's main home. This is problematic where a person has several residences. The test for a main home in such circumstances has been historically difficult, as was illustrated recently in *Commissioner of Inland Revenue v Diamond*.⁶⁶ The factors assessed in determining a person's main home include, but are not limited to, the period of time that the person occupies the dwelling and their employment, business

61 *Inland Revenue Regulatory Impact Statement*, above n 10, at 10.

62 At 11.

63 At 11.

64 At 11.

65 Yvonne Liu "Land rich levy eyed to plug duty loophole" *South China Morning Post* (online ed, Hong Kong, 3 March 2010).

66 *Diamond v The Commissioner of Inland Revenue* [2014] NZHC 1935, (2014) 26 NZTC 21,093 at [54]-[60]. Note that this case was unsuccessfully appealed. See *Commissioner of Inland Revenue v Diamond* [2015] NZCA 613 at [2]-[3].

interests, social ties and economic ties to the area where the dwelling is located.⁶⁷ These subjective factors may make the test difficult where a person has more than one main home, although that class of case will probably be minimal.

The legislature has moved to clarify at what point—or over what timeframe in the bright-line period—a property must be the *main home* for the exemption to apply. Issues nonetheless remain. Suppose two single individuals, A and B, each own a home separately. If A and B were to become one household, one of the individuals would likely need to sell their house. It is unclear whether such a sale will be taxable under the rule or exempt as a main home.

An equally complex part of the rule relates to homes owned by trusts. As outlined in Part IV, under certain circumstances, a taxpayer will be precluded from claiming the main home exemption if the home is owned by a trust. While this article does not examine the rules relating to trusts in any further detail, it should be noted that the separate rules for trusts are yet another example of a complexity that was not considered prior to the announcement of the bright-line rule.

Finally, as mentioned already, the Act limits the applicability of the main home exemption if it has been used more than two times in the last two years. This appears to be an ad hoc addition to the rule, given that it was not raised in either the Issues Paper or the Regulatory Impact Statement. This feature of the Act may also be difficult to apply, given the uncertainties in determining the appropriate two-year period.

VII Is the Rule Consistent with the Rest of the Income Tax Act?

Minimising compliance costs involves not only reducing the complexity of the rule as a whole, but also making it consistent with existing land sale rules where possible.⁶⁸ This part of the article seeks to demonstrate that a number of parts of the rule are inconsistent with other areas of the Income Tax Act. As no justification has been made for these inconsistencies, it is argued that these parts of the rule should be amended to make s CB 6A consistent with the Income Tax Act as a whole.

A *Start and end dates for the bright-line rule*

To be taxable under s CB 6A, the property must have been acquired and disposed of within two years. The date of acquisition is the date of registration of title, while the date of disposal is the date that the agreement for sale and purchase is entered into.

Having the end date as the date the agreement for sale and purchase is entered into is the right option. After all, if the end date were the date of registration of title, a seller would be able to artificially defer this date so as to fall outside the two-year period and avoid paying tax.

However, having the start date as the date of registration of title is problematic. The Issues Paper notes how having the start date as the date of registration of title is advantageous because a clear date is recorded on Landonline (the official system of land registration in New Zealand).⁶⁹ The date of registration of title is also the final stage of the

67 Inland Revenue *An officials' issues paper*, above n 25, at 14.

68 Inland Revenue *Regulatory Impact Statement*, above n 10, at 4.

69 Inland Revenue *An officials' issues paper*, above n 25, at 7.

purchase process. Given that the end date is the date in which the agreement for sale and purchase is entered into (the earliest stage of the purchase process), the period for the bright-line is the shortest that it possibly could be. This may be seen as *unfair*.⁷⁰

More importantly, having the date of acquisition as the date of registration is inconsistent with the Income Tax Act as a whole. Prior to the introduction of the bright-line rule, the date of acquisition had an important role to play in sub-pt CB of the Income Tax Act. It is used to determine when a taxpayer's intention is relevant for the purposes of s CB 6, as well as for the 10-year rules in ss CB 9 to CB 12 and s CB 14.

Uncertainty as to the date of acquisition became such a problem to the extent that officials released an Issues Paper on the matter in 2013.⁷¹ That paper noted how having the date of acquisition as the date a person enters into a sale and purchase agreement would provide "greater certainty" and be "more economically efficient".⁷² This resulted in the addition of s CB 15B, which provides that the date of acquisition is the date that a person enters into a sale and purchase agreement. Changing the start date to the date the agreement for sale and purchase is entered into would improve consistency with the Income Tax Act as a whole. It would also mean that a specific rule for "off the plan" sales and purchases is not required (as is currently the case).⁷³

B Losses

Losses under the bright-line rule will be ring-fenced: if a sale is taxable solely under s CB 6A, the taxpayer will be able to offset a loss only against gains from other land-sale rules. Ring-fencing is common in most CGT regimes,⁷⁴ but that does not mean it is the correct approach in this instance. The purpose of this section is not to assess the merits of ring-fencing generally. Rather, it is to show that ring fencing in this instance is inconsistent with the rest of the Income Tax Act. Indeed, losses are not ring-fenced if they are taxable under another land sale rule.⁷⁵ This inconsistency is not just a theoretical problem. In fact, it threatens to derail the applicability of s CB 6A altogether.

Naturally, taxpayers who have sold residential property at a loss will try to argue that their actions are taxable under s CB 6—that is to say, they actually brought the property with the intention of selling it—rather than under s CB 6A. They will do so in order to fully offset their losses against their total income. Anyone who might be caught under s CB 6A will thus try to argue that they actually *did* buy the property with the intention of selling it. This will revert the enquiry back to the problematic subjective intention test that the bright-line rule was designed to avoid in the first place. This has the potential to

70 Inland Revenue *Regulatory Impact Statement*, above n 10, at 7.

71 Inland Revenue *Clarifying the Acquisition Date of land—An Officials' Issues Paper* (Inland Revenue, Wellington, May 2013).

72 At 12. See also Inland Revenue "Clarifying the Acquisition Date of Land" (2014) 26(7) Tax Information Bulletin 86.

73 See Inland Revenue "Technical tax area: Taxation (Bright-Line Test for Residential Land) Act 2015" <www.ird.govt.nz>. See Taxation (Bright-line Test for Residential Land) Act, s CB 6A.

74 Australia and the United Kingdom ring fence losses. See Sharma and Davey, above n 3939, at 121.

75 The only ring fencing of losses in the Income Tax Act relates to controlled foreign companies. See section IQ 2.

dramatically increase the cost of administering the rule, for it will be in every taxpayer's best interest to argue that their activities are taxable under any land-sale rule other than s CB 6A.

Ring-fencing will also adversely affect those who are caught by the bright-line rule, even though they did not purchase the property with the intention of resale. This class of persons will most likely not be taxed under the land-sale rules again. Their loss will remain unusable as there will be no gain against which to offset it.⁷⁶ This is unfair as it effectively represents a one-way gain for the Government.

In other CGT regimes, losses are only ring-fenced against existing or future CGT liability. Ring-fencing is not limited to a *certain type of capital gain*, as it is under the bright-line rule.

It is submitted that the inconsistent aspects of the rule ought to be amended if the rule is to have any chance of being a success.

VIII Conclusion

The Taxation (Bright-line Test for Residential Land) Act 2015 is a timely attempt to improve New Zealand's property tax rules. Whilst the underlying premise of the bright-line may be a good one, it fails to meet a number of key objectives.

The complexity of the bright-line, as evidenced by its anti-avoidance component and the recent additions to the main home exemption, means that it will not "[p]rovide an easier rule for Inland Revenue to enforce"⁷⁷—thus failing to satisfy the first objective of the Act. The rule adds considerable complexity to an already-complex set of rules. This is attested to by the number of delays in the legislative process, as well as the fact that many features of the rule simply were not contemplated at its announcement.

The second objective of the Act was to "[m]inimise the number of sales made taxable that were acquired without an intention of resale."⁷⁸ It is doubtful whether the Act will meet this objective, given that property speculators will likely change their behaviour and retain properties for more than two years so as to avoid liability under the bright-line. Those most likely to be caught by the rule will be people who have had to sell property due to circumstances outside of their control. This may give rise to vertical inequity.

The rule thirdly aimed to "[m]inimise compliance costs for taxpayers".⁷⁹ The Act has failed to achieve this because a number of parts of it are inconsistent with the Income Tax Act as a whole. The date of acquisition and the ring-fencing of losses are particularly problematic in this regard. These inconsistencies will increase uncertainty among taxpayers. Moreover, the ring-fencing of losses threatens to undermine the very applicability of the rule, for taxpayers will simply seek to argue that they *did* purchase the property with the intention of resale so as to fully offset losses.

Whilst there are a number of inherent problems with the rule, it may be a success if the inconsistent and unnecessary complex aspects of it are amended. Given that the rule has the potential to improve New Zealand's property tax rules, amendment of these aspects is to be encouraged. Only time will tell if Parliament is that way inclined.

76 Sharma and Davey, above n 39, at 127.

77 Inland Revenue *Regulatory Impact Statement*, above n 10, at 4.

78 At 4.

79 At 4.