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RESIDENTIAL LAND SALE AND HOW THE "BRIGHT-LINE TEST" WILL BE APPLIED

Start Date

Bright-line test only applies to sales of residential land where the first interest in the land was acquired on or after 1 October 2015. The relevant date is when is the date on which a person enters into an agreement to purchase the land. This means that the bright-line test will generally only apply to the sale of land if the agreement for purchase of the land was entered into on or after 1 October 2015.

The bright-line period timeframe

Profits made from the disposal of residential land acquired between 1 October 2015 and 28 March 2018 will be taxable income of the vendor where the relevant residential land is disposed of within two years of acquisition

Profits made from the disposal of land acquired between 29 March 2018 and 26 March 2021 will be subject to tax if the land is disposed of within five years of acquisition.

Profits made from the disposal of land acquired on or after 27 March 2021 will be subject to tax if the land is disposed of within 10 years of acquisition, except if the property was acquired as a result of an offer made by the purchaser on or before 23 March 2021 and not able to be revoked before 27 March 2021 (in which case the five-year bright-line test will be relevant).

An exception from the ten year bright-line test is "new build land", acquired on or after 27 March 2021, which will continue to fall under the five-year bright-line test, subject to some limitations. New build land generally refers to a self-contained residence, if a code compliance certificate has been issued on or after 27 March 2020. This includes hotels and motels that are converted into self-contained residences, as well as modular and relocated homes.

When determining which bright-line test applies, the acquisition date is generally when there is a binding agreement between the purchaser and the seller. In most cases, this is a different date to that used when calculating a person's period of ownership for the bright-line rules. Generally, in a standard residential property transaction, the date of acquisition of residential land for the purposes of the bright-line test will usually be the date on which the instrument to transfer the land to the owner was registered. The date of disposal of residential land for the purposes of the bright-line test will usually be the date on which the owner enters into an agreement to sell the land.

There will be different dates of acquisition in different circumstances, including:

- buying "off the plan", where the date of acquisition is the date on which the owner enters into the contract to buy the land;
- subdividing and selling land, where the date of acquisition is the date on which the owner originally acquired the undivided land (or, in the case of a trust, the earliest date on which a trustee of the trust acquired the undivided land);
- converting a leasehold interest with a perpetual right of renewal into a freehold interest in the land, where the date of acquisition is the date on which the owner acquired the lease; and
- in the case of a trust, the earliest date that a trustee of the trust acquired the land.

In 2017, the *Taxation (Business Tax Exchange of Information, and Remedial Matters) Act 2017* (the Act) clarified that where land is held by a trust and then sold or subdivided, the acquisition date of the relevant land will be the date on which the land was first registered under the name of a trustee of the trust.

Definition of residential land

The bright-line test only applies to "residential land". Residential land is defined under *s YA 1* of the Income Tax Act 2007 as:

- land that has a dwelling on it;
- land where the owner is party to an arrangement to erect a dwelling on it; or
- bare land that may be used for erecting a dwelling under the relevant operative district plan.

Residential land does not include farmland or land that is used predominantly as business premises.

Residential property used to provide short-stay accommodation, where the accommodation is provided in a dwelling that is not the owner's main home, is subject to the bright-line test.

Residential properties that are vacant are still subject to various tax rules, such as the bright-line test, residential land withholding tax and the ring-fencing rules for deductions.

"Dwelling" is now defined as meaning:

> any place configured as a residence or abode, whether or not it is used as a place of residence or abode, including any appurtenances belonging to or enjoyed with the place…

This definition is then modified for the purposes of the main home exclusion to the bright-line test and, in that context, includes certain serviced apartments but excludes rest homes and retirement villages.

What counts as a disposal?

Residential land will not always be disposed of by entry into an agreement for sale. The bright-line test will also capture:

- some subdivisions of residential land;
- the conversion of leasehold interests with perpetual rights of renewal into freehold interests;
- a compulsory acquisition of land (eg under the *Public Works Act 1981*);
- mortgagee sales;
- a gift of land; and
- any other type of disposal.

Tax will not be payable under the bright-line test in respect of transfers of residential land where:

- the land was the main home of the vendor (the "main home exemption");
- the land is being transferred as an inheritance from a deceased person's estate; or
- the land is transferred as part of a relationship property settlement.

The recently enacted *Taxation (Annual Rates for 2021-22, GST, and Remedial Matters) Act 2022* introduces ***rollover relief*** allowing for technical changes to the ownership of land to be effected without triggering the bright-line rules. The legislation is retrospective so that from 27 March 2021, certain transfers of legal ownership of a property are ignored if the effective ownership remains the same. For example, some property transfers to or from a family trust, joint tenancies converted to tenancies in common and vice vera would be disregarded.

We will cover the rollover relief is a separate article.

Main home exemption

The most significant exemption from the bright-line test is the exemption for the disposal of a person's main home. In March 2021, amendments were made to the main home exemption for property subject to the 10-year bright line test (ie property acquired on or after 27 March 2021 except as a result of an offer made by the purchaser on or before 23 March 2021 that could not be revoked before 27 March 2021). Under the amended main home exemption:

- to be within the exemption, there is a requirement that the property has been used predominately (on a floor area basis) as the taxpayer's main home;
- the exemption no longer applies on an all or nothing basis, and instead is applied to reflect the period(s) of a taxpayer's actual use as a main home;
- a taxpayer's use of a property for purposes other than as a main home will not need to be accounted for (ie the main home exemption will continue to apply) if the period of other use is for less than 12 months at a time; and
- a taxpayer will be required to pay tax under the bright-line test in respect of periods where the property's use was for purposes other than as their main home (subject to the 12-month permitted adjustment(s) mentioned above).

The bright-line test rules provide that the main home exemption cannot be used if the seller has already used that exemption twice in the two years immediately before the date of disposal. The exemption will also be unavailable for use by a person, or group of persons, who has a regular pattern of buying and selling their main home. A "group of persons" is defined in *s CB 16A(5)* of the Income Tax Act 2007 to mean:

- two or more persons (natural persons) when together they occupy, or have occupied, the residence; and
- includes non-natural persons if a natural person has significant involvement in, or control of, the activities of the non-natural person.

The main home exemption under the bright-line test can generally be used where the land is held by a trust, provided that:

- the land was the main home of a beneficiary of the trust;
- the vendor(s) is a trustee of the trust (which would almost always be the case where the land being sold is held by a trust); and
- the principal settlor of the trust does not have a main home or, if the principal settlor of the trust does have a main home, it is the principal settlor's main home that is being disposed of.

Ring-fencing of losses

If residential land is bought and sold at a loss within the bright-line test two-year, five-year or 10-year (as applicable) timeframe, these losses can be ring-fenced. This means that the loss will be carried forward to the next income year (provided that any relevant general continuity requirements are met, and continue to be met) and can be used only to offset against future taxable income that arises under the land sale.

Additional ring-fencing rules may apply in relation to a person's expenditure in connection with residential investment property. With effect from the 2019-20 income year, an investor is no longer able to deduct expenditure relating to their loss-making residential investment property from their other income. Instead, these deductions will be "ring-fenced" and carried forward to offset against the investor's future residential rental income or income arising on the sale of residential land.

The ring-fencing rules apply to “residential land”, as defined for the purposes of the bright-line test (see The “bright-line” test for sales of residential land — Definition of residential land) other than residential land that is:

- the person’s main home;
- subject to the mixed-use asset rules;
- identified to Inland Revenue as being taxable on sale;
- owned by widely-held companies; or
- certain employee accommodation.

Following the enactment of the *Taxation (Annual Rates 2020-21, Feasibility Expenditure and Remedial Matters) Act 2020*, the definition of the “residential land” now includes residential properties used to provide short-stay accommodation (such that the losses from these properties are also ring-fenced). This change applies from the 2021–22 income year onwards, regardless of when the property was acquired.

The ring-fencing rules will apply across an investor’s residential property portfolio (meaning that the deductions from one residential property may be used to offset against income from another residential property) unless the investor has elected to apply the rules on a property-by-property basis.

Specific rules exist to prevent the use of interposed entities to undermine the rules. Where a taxpayer has borrowed money to acquire an interest in an entity that is a “residential land-rich entity”, the taxpayer’s permitted interest deductions to the residential rental property income of the entity is limited.

Interest deductions

The Government has enacted legislation which largely removes interest deductions for residential rental property owners from 1 October 2021.

Interest incurred on residential property (including bare land zoned for residential use) acquired on or after 27 March 2021 will no longer be deductible from 1 October 2021 under the new rules. For property acquired prior to 27 March 2021, it is proposed that deductions will be phased out over the next four years as follows:

Period that transitional residential interest is incurred	Percentage denied
1 October 2021 to 31 March 2022	25 per cent
1 April 2022 to 31 March 2023	25 per cent
1 April 2023 to 31 March 2024	50 per cent
1 April 2024 to 31 March 2025	75 per cent
On and after 1 April 2025	100 per cent

Interest incurred on “new build land” will not be subject to these proposed changes and will continue to be fully deductible, to the extent the interest is incurred before the date that is 20 years after the earliest of the following dates:

- the date on which the code compliance certificate described in is issued;
- the date that, in the records of a local authority or building consent authority, the relevant conversion or remediation is recorded as having been “completed”, or
- the date that the relevant building work is entered into the records of a local authority or building consent authority as “substantially completed”, in the case of a code compliance certificate being issued.

"New build land" is defined as land to the extent to which it has a place that is configured as a self-contained residence or abode, provided that a code compliance certificate has been issued for it on or after 27 March 2020. This includes hotels and motels that are converted into self-contained residences, as well as modular and relocated homes.

Other exemptions from the interest denial rules are also proposed. These include:

- a land business exemption, that will apply for interest relating to land held as part of a developing, subdividing or land-dealing business; and
- exemptions for specified property types such as retirement villages and rest homes, a portion of the main home if it is used to earn income (eg from flat mates or boarders) and student accommodation.

Build to Rent

In a newly introduced tax bill, the the Government has provided an in-perpetuity exemption from the interest limitation rules for build-to-rent dwellings that meet the asset class definition. The proposed amendments would take effect on 1 October 2021 to align with the introduction of the interest limitation rules.

"Build-to-rent land" would mean land to the extent to which, together with any other contiguous land owned by the same person:

- has 20 or more dwellings;
- each dwelling is used, available for use, or being prepared or restored for use, as a dwelling occupied under a residential tenancy to which the *Residential Tenancies Act 1986* applies;
- every residential tenancy has the option of a 10-year term, with the ability to give 56 days' notice of termination;
- every tenancy agreement includes a personalisation policy; and
- at no time it after it first meets the above requirements does it fail to meet those requirements.

The exemption would apply to existing dwellings that meet the definition by 1 July 2023, as the Government envisages it is highly unlikely any existing developments would have offered 10-year tenancies to all tenants.

Land-rich companies and trusts

The bright-line provisions include an anti-avoidance rule designed to prevent people from using land-rich companies and trusts to avoid being caught by the bright-line test. Land-rich companies or trusts are those where 50 per cent or more of the value of the company or trust is attributable (directly or indirectly) to residential land.

A disposal of residential land by a land-rich company will be deemed to have occurred when:

- 50 per cent of the shares in the company are disposed of within a 12-month period;
- some of the company's residential land was acquired within the 10 or five year (as applicable) bright-line period of the disposal of the shares; and
- the disposal of shares had a purpose or effect of defeating the intent and application of the bright-line test.

In these circumstances, the land-rich company is deemed to have disposed of the residential land (being the residential land that was acquired within 10 years or five years (as applicable) prior to the disposal of the company's shares) to the disposing shareholder at cost price. The shareholder is then deemed to have immediately disposed of the relevant land back to the company at market value. The net result is that the shareholder will have taxable income (or a deduction, as appropriate) equal to their share of the difference in the cost price of the land and its market value.

Similarly, a disposal of residential land by a land-rich trust will be deemed to have occurred when the trust owns residential land, directly or indirectly, and:

- any of the following changes are made:
  - the trust deed changes;
  - a decision-maker under the trust deed changes; or
  - an arrangement under the trust changes; and
- the change was made with a purpose or effect of defeating the intent and application of the bright-line test.

In these circumstances a trustee of the land-rich trust is deemed to have disposed of the residential land (being the residential land that was acquired within 10 years or five years (as applicable) of the relevant change to the organisation of the trust) at market value. The net result is that the trust will have taxable income (or a deduction, as appropriate) equal to the difference in the cost price of the land and its market value.

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