PROPERTY DEVELOPMENT AND TAX

by
MATTHEW GILLIGAN, *CA*

CHARTERED ACCOUNTANTS & PROPERTY EXPERTS

Tel: 09 522 7955
Email: info@gra.co.nz
www.gra.co.nz

If you are going to develop property, then complex tax rules come into play and there is no avoiding that. Hopefully I can give you some guidance to help demystify these rules, but to be clear, this is not a substitute for specific advice. When it comes to the application of income tax and GST to property sales, the specifics matter. I would always recommend that you seek professional advice on these issues.

By way of background, there are 10 provisions in the Income Tax Act 2007 that can apply when you sell property. I do not propose to run through all 10 of them. Instead, I would like to focus on three in particular:

- ***The bright-line rule***
- ***A provision that applies where you commence a more than minor subdivision within 10 years***
- ***A provision that applies where you are regarded as having carried on a profit-making scheme.***

Besides income tax, you should also be aware that GST can apply where you develop property to sell.

The Bright-Line Rule

Starting with the bright-line rule, this applies where residential property is bought and sold within a particular timeframe. When the rule was first enacted from 1 October 2015, the bright-line period was two years. It subsequently got extended to five years for property bought on or after 29 March 2018, and most recently was extended to 10 years for property purchased on or after 27 March 2021.

This means if you are selling residential property, and want to know if the bright-line rule applies, the first step is to determine whether the two, five or 10-year period is applicable. You determine the relevant bright-line period by looking at the date that you entered into the sale and purchase agreement. If you entered into the sale and purchase agreement on or after 27 March 2021, for example, then the 10-year period will apply.

Once you have determined the relevant bright-line period, if sale occurs

within that period, then any gain you make will be taxable – unless an exemption applies.

The primary exemption to be aware of is the "main home" exemption. Like most things in tax, what should be relatively simple is becoming increasingly complicated. I say this because the main home definition has recently changed. For the purposes of this discussion, though, the key point is that in order to qualify for the main home exemption, the property in question needs to be mainly used as your home. This means that if you, for example, rent out 80% of the dwelling while occupying the remaining 20% as your home, it might be your home in general parlance, but it will not be your main home as far as the bright-line rule is concerned.

To help illustrate how the bright-line rule works, let's consider some examples.

Case Study 1

Q. *Walter enters an agreement to buy a residential rental on 20 March 2021. The purchase settles on 30 April 2021. After holding the property as a rental for three years, he sells it in 2024. Is Walter taxable on sale?*

A. Yes, he is. In this case the five-year bright-line rule applies because the sale and purchase agreement was entered into before 27 March 2021 when the bright-line period extended to 10 years. Walter has then sold the property within five years of purchase. The property is a rental, so he does not get the benefit of the main home exemption and tax is payable on any gain.

Case Study 2

Q. *Jesse and Skyler enter into an agreement to purchase a new home on 1 June 2021. They move in but 12 months later Jesse is relocated at work, and they decide to sell up. They want to know if they are taxable on sale.*

A. No they are not. In this case, the 10-year bright-line period applies because the sale and purchase agreement was entered into after 27 March 2021. As they are selling the property within 10 years, then on

the face of it any gain is taxable. However, Jesse and Skyler qualify for the main home exemption having occupied the property as their home since purchase.

Case Study 3

Q. *Gus enters into an agreement to purchase a new home for himself and his family in June 2020. In June 2021 he commences a subdivision which sees him dividing the property into two, with the existing dwelling sitting on the front and a new bare lot on the back. It is now January 2022, and he is considering selling both the existing dwelling and the bare lot of land. He wonders if he will be taxable under the bright-line rule.*

A. Again, the first step is to work out the relevant bright-line period. In this case it is five years. As Gus is selling within five years, on the face of it any gain is taxable. However, he has occupied the dwelling as his home since purchase. The question then becomes: can he claim the main home exemption if he sells a bare section of land post-subdivision?

Gus has not lived in a dwelling on the bare lot of land, suggesting that he may not be able to claim the main home exemption. However, the IRD have confirmed that as long as the land was primarily used as part of his home for most of the time that he owned it, then he can claim the exemption even if there is no dwelling on it. The key point here is the back section was Gus's backyard that his family used as part of their private residence up until the point of sale. Accordingly, he can claim the main home exemption. He can also claim the main home exemption on selling the existing dwelling. However, you should be aware that there are limits on how often you can claim the main home exemption. You cannot claim it more than twice in a two-year period and you cannot claim it if there is a regular pattern of buying and selling your main home.

Case Study 4

Q. *Saul and Marie own a lifestyle block and would like to subdivide off two sections to gift to their two daughters. The subdivision is straightforward and low cost. These is very little physical work involved. They bought the*

land 15 years ago and it is owned in a trust. They want to know if there are any tax consequences for the trust on completing the subdivision and transferring two titles to their daughters, and whether their daughters would face any bright-line issues moving forward.

A. The trust is not subject to any bright-line issue, as it has held the land for 15 years. Although a subdivision has been undertaken, it is minor, and the trust will not have any tax to pay on any deemed sale as a result of this. As far as the daughters are concerned, they will be deemed to have acquired the land in 2021 at a time when the bright-line period is 10 years. Accordingly, they will be subject to the bright-line rule should they on-sell the properties within 10 years. However, they may be able to claim the main home exemption if they build houses on the land that they then occupy as their homes.

The Subdivision and Profit-making Scheme Provisions

Independent of the bright-line rule, there are other income tax provisions that can capture you if you carry out a subdivision involving work of more than a minor nature within 10 years of acquiring the land, or sell land as part of a profit-making scheme.

In order to be caught by the subdivision provision there is a requirement that the subdivision be more than minor in nature. Unsurprisingly, the IRD have a very narrow view of what constitutes "minor", so what you might view as a low-scale subdivision can be caught.

There are exemptions from this provision. There is a "residential home" exemption, which, while similar to the "main home" exemption from the bright-line rule, has some differences. A key technical point to note in relation to this exemption is that it does not apply if a trust is the owner of the land. There is also a rental exemption, meaning that if you develop and subdivide land for the purposes of deriving rental income, then any subsequent sale of the rental property is not taxable merely because you commenced a more than minor subdivision within 10 years.

The profit-making scheme provision kicks in if you sell property as part of a profit-making scheme or undertaking. An example of this is building a house and selling it upon completion. Even though you might be building on land that you have owned for many years, and therefore sit outside of the bright-line rule, the profit-making scheme provision can apply. Again, the application of these provisions is best illustrated through example.

Case Study 5

Q. *Let us return to the example above of Gus who subdivides a section off the back of his home for sale. Let's change the facts slightly so that the sale occurs after more than five years have passed since purchase. Is the sale taxable?*

A. This means the sale is not subject to the bright-line rule. However, as the subdivision commenced within 10 years, it could be captured by the subdivision provision. Generally speaking, though, a subdivision of one into two stands every chance of being viewed as minor. Furthermore, as the subdivided section has come out of a larger area of land that was occupied by him as a home prior to the subdivision commencing, he can get the residential exemption.

Case Study 6

Q. *Hank lives in a dwelling on an 800m² site. He purchased the property in 2017. He is now proposing to subdivide into five lots with the existing dwelling sitting on one lot. He will build four new dwellings on the four remaining lots, which all be sold. He wants to know the tax consequences of this.*

A. In this case, the subdivision and sale of four lots post-completion of building would be taxable. As the subdivision is commencing within 10 years and is more than minor, it would be caught by the subdivision provision. However, Hank may be able to claim the residential exemption, as the land was used as is home prior to subdivision commencing. It is the profit-making scheme provision that catches him, as the construction of four dwellings for sale would be regarded as a profit-making scheme.

Case Study 7

Q. *Hank changes his mind. Instead of selling the four new dwellings he decides to keep them and sell the existing home. Is there tax to pay on this sale?*

A. In this case there may not be tax to pay on the sale of the existing home. As Hank bought the land in 2017, the bright-line rule does not apply. Although he is commencing a more than minor subdivision within 10 years, he is selling land that has come out of a larger area of land that was occupied by him as a home prior to commencing the subdivision. As long as he does not own the property in a trust, he will qualify for the residential exemption.

He will also likely qualify for the rental exemption on the basis that the purpose of the subdivision is the generation of rental income by retaining four new dwellings for rental purposes. The sale of the existing dwelling, rather than the new builds, is also less likely to be viewed as a profit-making scheme.

GST

Income tax is not the only tax you need to beware of if you are developing and selling property. Let's revisit the last two examples and ask the question whether GST would apply on sale.

***Case Study 6* – Part 2 – GST**

In Case Study 6 above, Hank subdivides and develops his home property through building four new townhouses for resale purposes. This constitutes a taxable activity for GST. This means GST will be payable on sale. This is despite the fact that Hank did not claim GST when he bought the property and is not GST registered. This can be a real trap for homeowners who think that because they are developing a property which they have occupied as a home, there are no tax implications and certainly no GST implications. That is not the case.

***Case Study 7* – Part 2 – GST**

In Case Study 7, instead of selling four completed dwellings, Hank sells the existing dwelling and keeps the four new dwellings for rental purposes. In this case, the sale of the existing dwelling is arguably not subject to GST. The main purpose of the development is the production of residential rental income. Developing property to provide residential accommodation is an exempt activity as far as GST is concerned. This means the sale of the existing dwelling should not be subject to GST. The eventual sale of townhouses years down the track after periods of rental should also be free of GST.

Caution

While I hope the above examples provide you with some useful background on the potential income tax and GST implications in developing property, I cannot emphasise strongly enough the need to get specific advice. The above covers just a few of the relevant income tax provisions. There are other provisions that can apply, including "tainting" provisions and a very tricky section of the Income Tax Act that applies where you sell property that has been rezoned or the subject of a resource consent being issued. The slightest variation in facts or ownership structure can generate different tax consequences. We encourage all property owners who are considering property developments to get specific tax advice.

At GRA we specialise in providing advice in relation to the tax and structure issues associated with property development, and we welcome the chance to advise you regarding yours.

GILLIGAN ROWE + ASSOCIATES LP

CHARTERED ACCOUNTANTS & PROPERTY EXPERTS

Tel: 09 522 7955 | Email: info@gra.co.nz | **www.gra.co.nz**

Copyright © 2021 Gilligan Rowe & Associates LP

The information in this publication is intended to provide only a summary of the issues associated with the topics covered. It does not purport to be comprehensive nor to provide specific advice. No person should act in reliance on any statement contained within this e-book without first obtaining specific professional advice. If you require any further information or advice on any matter covered herein, please contact info@gra.co.nz or call 09 522 7955.