Tax Tonic April 2022

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GST registration and one-off spike over $60k

Q: Person providing personal services, or retail, cannot add GST onto the retail price, which means once registered the supplies will go down to $52,173. Do they wait till their turnover is $69,000.00?,

> *A: Sorry, it doesn't work that way. Section 51 requires registration "where the total value of supplies" exceed $60,000. The "value" of a supply is a GST exclusive concept. Under section 10(2) of the GST Act the equation can be phrased as:*
>
> value of supply + tax charged = consideration (as defined).
>
> *Therefore it is only when the GST exclusive value exceeds $60k that a person must register.*

Q: So, if a property is purchased off the plans and then sold on settlement. Would we have a GST issue if there is no historical pattern?

> *A: You will recall we discussed this during the webinar and expressed doubts as to whether it could be applied in this manner.*
>
> *First, as a bit of background. A person who does a one-off 'spec home' has a taxable activity in our view. It is difficult to argue it should be treated as a minor one-off like the CIR v Newman Court of Appeal case (a builder who subdivided a private section into two lots and sold the bare land). A spec home development has a large scale of continuous activity leading to the sale of the property, eg. buying the land, planning and consents, foundations, construction, power, water & telecom, landscaping, marketing for sale etc. Even if a person used a third party building firm (like GJ Gardners), the building firm is simply acting as agent for the taxpayer.*
>
> *So, recognising the one-off spec home sale is a taxable activity, can we apply the same logic as the webinar Charity example to say there is no requirement to register?*
>
> Subject to this Act, every person who, on or after 1 October 1986, carries on any taxable activity and is not registered, becomes liable to be registered—
>
> (a) at the end of any month where the total value of supplies made in New Zealand in that month and the 11 months immediately preceding that month in the course of carrying on all taxable activities has exceeded $60,000 …
>
> **provided** that a person does not become liable to be registered by virtue of this paragraph where the Commissioner is satisfied that the value of those supplies in the period of 12 months beginning on the day after the last day of the period referred to in the said paragraph will not exceed that amount:
>
> b) at the commencement of any month where there are reasonable grounds for believing that the total value of the supplies to be made in New Zealand in that month and the 11 months immediately following that month will exceed the amount specified in paragraph (a):

Remember, the HandsUp charity example bought and sold the house in Nov 2021.

The "commencement of any month" in (b) is not necessarily Nov 2021, but it could be implied that you have to apply the test to all possible months ie. a kind of rolling test, not just picking one month. Under this approach, if we use November we are already over $60 either going back 11 months or forward 11 months, which would mean the Charity has to register 1 Nov.

The wording is ambiguous. As discussed in our webinar, if (b) can be interpreted to include November, what is the point of the Proviso?

Drummond case
In C of IR v Drummond (1998) the High Court held GST registration was not required for the sale of a forest. Because the trust had sold the forestry earlier than was intended (ie before the trees had reached maturity), the sale was the <u>cessation</u> of a taxable activity, rather than the <u>termination</u> of a taxable activity in terms of s 6(2) as it was worded at the time.
*The case was also about the registration rule in **s 51(1)(c)**, where registration is not required if the value of supplies exceeds $60k because the scaling down, or cessation, of business.*

Following this case, the Govt amended s 6(2) to include within the definition of a "taxable activity" anything done in connection with the beginning, ending or <u>premature ending</u> of a taxable activity.

The facts in Drummond were that the Trust decided to sell the forest before maturity. To enable this, the Trust undertook a subdivision of the farm into three lots comprising 72.84 hectares (Lot 1 – the forest), 29.65 hectares (Lot 2), 12.25 hectares (Lot 3). Tenders were called for the sale of all three lots, or any one. As a result a tender was received from a buyer for the 72.84 hectare Lot 1, and the tender was accepted in the sum of $464,625.00. Settlement occurred in October 1992.

The judge in Drummond said:

> "Section 51(1)(b) would clearly apply in this case because of the total value of the supplies involved. Nevertheless it is subject to the proviso contained in s 51(1)(c).

Unfortunately the judge did not discuss the proviso to s 51(1)(a) and how this should interrelate with (b). The judge's statement that (b) "would clearly apply" suggests that in our webinar HandsUp Charity is liable to be registered.

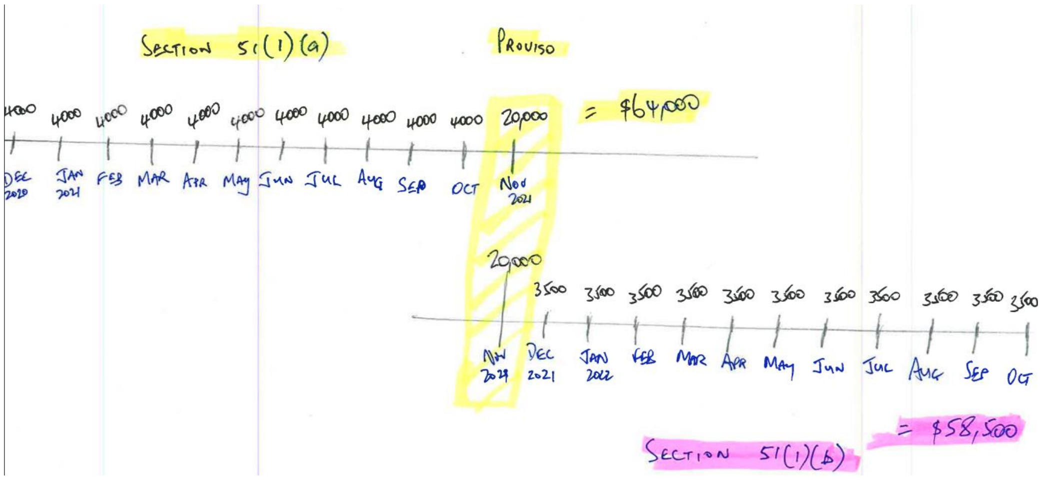
Summary

We seem to have opened a can of worms!!

Our HandsUp Charity example and the above one-off "spec home" example could be contentious if we decided they didn't need to register and IRD reviewed. We think the likely IRD view it to pick any month, and going 11 months back including that month, and then forward 11 months including that month.

This would catch the HandsUp and spec home scenarios, and would have the same result as Drummond after the Govt amendments to s 6(2).

The following diagram helps illustrate the "safe" interpretation.



Say HandsUp had taxable supplies of $4,000 per month, then in Nov 2021 had a spike of $20,000. Total supplies are $64,000. However it expects its revenue over the next 11 months to drop to $3,500 per month. Therefore the supplies from Nov 2021 plus 11 months is $58,500. HandsUp is not required to register in Nov 2021 when it hit $64k as the proviso relieves it from registering, and it satisfies para (b) by remaining under $60k for the following 11 months.

Q: With regards to the Forestry example (GST one off supply) wouldn't it be better to ask for one large payment instead of several payments over a few months?

A: Agreed, if possible. But also note our comments for the question above.

Q: With the Charitable Trust Charity Auction, are the donated items being auctioned not GST exempt (ie donated goods), therefore no GST Outputs to account for?

A: Good question. Section 14(1)(b) includes as an exempt supply: "the supply by any non-profit body of any donated goods and services".
In the webinar example the house was not donated by the builder. The HandsUp charity purchased it from the builder (at a discounted cost) and then on-sold it.

Q: Are Covid-19 Payments considered one-off spike?

A: When Covid-19 began and the Government commenced its subsidy program, it introduced legislation to exempt the Covid-19 grants from GST. Therefore they do not impact on the $60k registration threshold as they are exempt from GST.

Interest denial, bright-line, rollover etc

Link for the report: **Special report on interest limitation and additional bright-line rules** released 31 March 2022 (212 pages!!)

https://taxpolicy.ird.govt.nz/publications/2022/2022-sr-interest-limitation-bright-line-changes

Original Supplementary Order paper some of which remains unchanged and on which the October 2021 webinar was based.

https://taxpolicy.ird.govt.nz/publications/2021/2021-commentary-sop-argrm-bill

Q: On developer / build criteria: Converting a garage or other separate outbuilding into a self-contained legal residential dwelling - the developer exemption allows deductions on [the whole property?] during development, and then the newly CCC'd outbuilding is now a new build and so a full interest claim on the cost of developing, and a partial for the underlying land?

A: No, the developer exemption refers to "the extent" the development is creating new build land so an apportionment will be required.

Q: Sub-question: Assuming acquired 1/4/21, what happens to bright line, is this now 5 years for the whole property as it comprises some portion of new build land? Or a nasty mixture of 5 and 10 years?

A: Correct on the nasty – it's an apportionment of 10 for non new build and 5 for new build

A: Q: I was wondering regarding the transfer of residential investment LTC shares into a trust - not explicitly included in the rollover provisions, but could it not be argued that the intention was to "look through" to the underlying shareholders? Or still safer to use the relationship property transfer to trust?

A: You are correct to wonder about this as if an LTC was a true look through for income tax purposes (which was the original purpose of the whole legislation) then yes it would work. IRD agree it is a look through for portfolios of rental property in the name of an owner and LTC but in other situations they argue differently. Given they are legislating that rollover applies from the LTC to the owner they are arguing in this case they are not already one and the same. I think this actually conflicts with their argument that you can portfolio between owner and LTC. I wouldn't risk it but maybe there is an argument to be had if it is a fait accompli when you find out about it!

Q: And yet IRD continue to challenge interest claims on new builds from time to time, ie during the build process.

A: Yes – left- and right-hand syndrome – very frustrating

Q: I'm interested in how to do the journals to balance the loan and where the interest is supposed to vanish to?

A: Good question. They are expecting everyone to do a tax adjustment or below the line non deductible. Interesting point here. For a standard company the interest will be a non-deductible expense which will reduce retained earnings and create excess ICs. On a wind up there won't be any additional tax on that denied interest if the shareholder is on a high tax rate. Minor comfort

Q: So, if you move two old houses onto two newly subdivided sections?

A: This would qualify for the developer's exemption before the CCC and the new build after the CCC.

Q: Slide #26 says ring fencing doesn't apply to mixed use property, does this extend to losses on BNB property rentals that are mixed use assets? (e.g., beach house).

A: Yes, correct and this is because MUA has its own ringfencing rules i.e., the revenue from 3rd parties must be more than 2% of the market value of the property at the end of the year otherwise the loss is ringfenced. This may still be relevant if it is repairs that cause the loss.

Q: Re slide 26 Airbnb and serviced apartments therefore defined as residential. Is the income for these still "commercial" for GST purposes? If so, sounds a bit mean?

A: Yes, it is subject to GST as it isnt someone's principal place of residence. Another definition for residential property that is inconsistent (correct it is mean!)

Q: For the highwater calc, are shares at MV counted?

A: I think you are referring to the "stacking method". This is the relevant portion of the legislation and it would be allowed property:

"For the purpose of **subsection (1)(b)**, the notional loan principal is calculated using the following formula, treating a negative amount as zero:

outstanding borrowings − allowed property.

Definition of items in formula

(3)

In the formula in **subsection (2)**,—

(a)**outstanding borrowings** is the principal of the underlying loan, determined as at 26 March 2021, to the extent to which it is for both disallowed residential property and property that is **allowed property** described in **paragraph (b)**:

(b)**allowed property** is the total of—

(i) the value of the person's assets, determined as at 26 March 2021, that is not disallowed residential property, but ignoring assets that are not used in deriving assessable income; and

(ii) to the extent to which the person's assets are disallowed residential property described in **section DH 4**, the value of those assets, determined as at 26 March 2021.

Q: Question on interest denial please. If an LTC owns an existing residential rental with a mortgage. They wish to add an extra bedroom and bathroom this portion will be a new build, financed via a new bank loan. Can the LTC claim interest on the new build portion of the loan?

A: Unfortunately, no. It could well need a CCC but because it does not include a new kitchen and separate entrance way. IRD also make the commented that for one house divided in two to both constitute new builds would require a fire wall…. not sure you could even have a connecting door in a firewall when I think about it.

Q: Developer - what is the definition of "commence" - after the plans have drafted up or drawing up the plans?

A: The following is an example from the Special report:

"Example 28: Undertaking or scheme

Brooke owns and manages ten residential rental properties. She also owns a large section of land that she decides to subdivide and build five additional townhouses on. She plans to sell the townhouses.
The development exemption begins when Brooke's undertaking or scheme to subdivide the land begins. For example, it may start once Brooke engages a company to survey the land and prepare the subdivision plan. When an undertaking or scheme begins will depend on the facts of each case.
Fact variation: Subdivision with no intention to create new build land
Assume the same facts, except that Brooke decides to subdivide the large section of land but has no intention of creating new build land herself. After she subdivides the section, Brooke sells it to a property developer. The development exemption does not apply to the land because Brooke subdivided the land without an intention to create new build land."

They are applying the same test that is used for the commencement subdivisions. Case law states it is the first "overt" act which is referring to something that shows the scheme has gone beyond the point of just contemplating it i.e., putting the plan in motion

Q: So, if a client has Overseas rental properties with foreign loans, properties purchased prior to 27/3/2021, there is no interest deduction at all.

A: As the interest denial rules don't apply to overseas property that will still be ok. This is aimed at NZ houses financed from offshore. They say because it's too complicated due to the exchange fluctuation. Good news is, if there is a gain on that it won't be taxable either

Q: Does the interest denial apply if the property purchased prior to 27 March 2021 but settled on 8 April 2022 which the loan was drawn down on 8 April 2022?

A: If the person has the first interest in the land prior to 27 March 2021 (signed contract) and doesn't nominate a new entity to settle after this loan will be subject to the phase out

Q: What happens with a residential home when the owners go overseas to work for a few years and rent out their house while they're away then come back to live in the house?

A: If it's less than 12 consecutive months you ignore it but if it's over 12 consecutive months you have to apportion. Eg. own for 8 years but absent for 2 years = ¼ taxable

Q: Can they claim interest under the new rules from the time they start renting out if applicable? Are they caught under the Bright line rules? Is there a difference if they come back and sell or come back in live in the property for a few years?

A: If this was a new build and was rented at some point the interest would be deductible. For bright-line only if absent from the property for more than 12 consecutive months. It doesn't matter whether the live in it or not after the 12 consecutive months is exceeded provided, they lived in it before the absence started

Q: Julie discussed the change of use rules for brightline. She mentioned that the construction period wouldn't be included in the 12 months absence when calculating the main home exemption. Does this rule now apply to properties purchased prior to 27 March 2021 when calculating the main home exclusion? They are subject to the predominant and most of the time rules which is effectively 50% of time and area. If the construction time for the house build wasn't included, then this would mean more people would meet the main home exemption on any main home they built in recent years.

A: Unfortunately, no this is only specific to the new main home definition.

Q: I'm just a bit confused about slides 25 & 28 where one has an exclusion for interest denial but other no exclusion. If you have a house, say 50% is solely used for Airbnb and 50% is for personal dwelling, does this fall under the exclusion under slide 25? Maybe you could clarify the differences between the two in the next webinar. Is predominate test meaning more than 50% main home or is it more than 50% Airbnb use?

Slide 25
Exclusions -Same for all three:
•Partial use of own **home** so long as meet the predominate test (e.g., flats mates or airbnb)

A: So, this point is considering where it is actually inside the home. I.e a bedroom(s) and could even be separate bathroom and kitchen so long as it's in the home and the homeowner has free access to it when it isn't airbnb or in the case of flatmates the area of the home less the area the owner doesn't have access to (flatmates bedrooms) is more than 50%, then the main home exemption overrides all 3 rules. Not sure if you recall but in the December 2021 webinar I talked about "flatmates" and that IRD were fine with a deduction for more than 50% of the costs being claimed for flatmates on the basis that for the main home the whole of the shared area was part of the owner's main home percentage as opposed to just the percentage used to calculate what was deductible. Quite concessional in my view but I have it in writing from the Chief Tax Counsel in relation to a specific case with a house where the owner had 3 and ½ flatmates (his girlfriend paid rent for her half of the bedroom). The deductible percentage was greater than 50% but no ringfencing was required because the owner's bedroom plus the shared areas together exceeded 50% and therefore it met the main home criteria. I have checked the example in the special report and it doesn't contradict this but *unfortunately in the case they use the owners exclusive use areas are more than 50%. Taxpayers are entitled to rely on statements in writing from the Chief Tax Counsel and woe betide an auditor who tried to argue with this.*

Slide 28
Bright-line doesn't apply to **minor residence/abode on main home** if predominately main home for entire bright-line period but interest denial does apply. Ring fencing doesn't apply if more than 50% of land is main home for most of the year.

A*: In this one I am talking about a* <u>*separate*</u> *minor dwelling that is a minor part of the main home land but is a separate structure. So long as the main home land is more than 50% of the total no brightline or ringfencing applies but interest denial does apply. This is a paragraph from the "Special report on interest limitation and additional bright-line rules – 31 March 2022" that elaborates further.*

"Where there are multiple residential properties on the same parcel of land (for example, a self-contained flat or cottage, sometimes advertised as "home and income"), only the property used by the owner as the main home qualifies for the main home exception. Thus, the carve-out from DRP only applies to the part that is the main home. Other self-contained units on the same title are DRP and subject to interest limitation under new subpart DH. This is the same result as if the multiple units or properties were on separate legal titles"

Q: Question on the "excluded from all 3" of the big residential tax sections, in the case of flatmates. You've said this is excluded from all 3, but what about where the private portion of the home is less than 50% (ie, 5-bedroom house, single owner occupant, with 4x couples staying in the other rooms). - The ringfencing specifically with the 50% of land is main home requirement (as per the main/minor dwelling problems)

A: Please see above

Q: In regards to the interest denial rules and exclusions, partial use of own home is excluded so long as the predominant test is met. What is that test? Example: dwelling with BNB attached. House is 75% and BNB 25%, can 25% interest continue to be claimed?

A: Another good question. It's clear if it was separate, it wouldn't be (as above). It's also clear if it was just part of the overall home, it would be i.e., bedrooms that the homeowner has direct access to when it's not used. Best answer is if the BNB attached is attached but separated from the dwelling in terms of no connecting entrance i.e., you have to go outside to get in it, it would not qualify but otherwise would. A fine line here and I think a similar issue comes up with new build i.e., when do you get to include the whole of the existing building as a new build and only a part.

LTC and FBT

Q: Can you please confirm that for an ordinary company travel to and from work is not personal travel. If a log book was kept under the new rules would the home to work travel be work travel. Same if privately owned and reimbursed is home to work business travel?

A: It is for any entity unless the vehicle is a work-related vehicle i.e., prominently and permanently sign written.

Q: What if one of William's children under 16 years old working part-time for the LTC? Is it subject to FBT?

A: Not if William owns a share but yes if William doesn't own any. Remember though if there's no FBT, private expenditure won't be deductible so only important for vehicles where FBT gives a better result and the other benefits exemption where you can claim the expense and not have FBT. 😉

Ex gratia payment on employees death

Q: Does Briteway need to file the wage with IRD or just pay the gross wage out to his spouse/partner?

A: No need to file anything with IRD. The payment is not taxable. The gross payment of $45k is simply paid to the spouse.

LTC and exit dividend

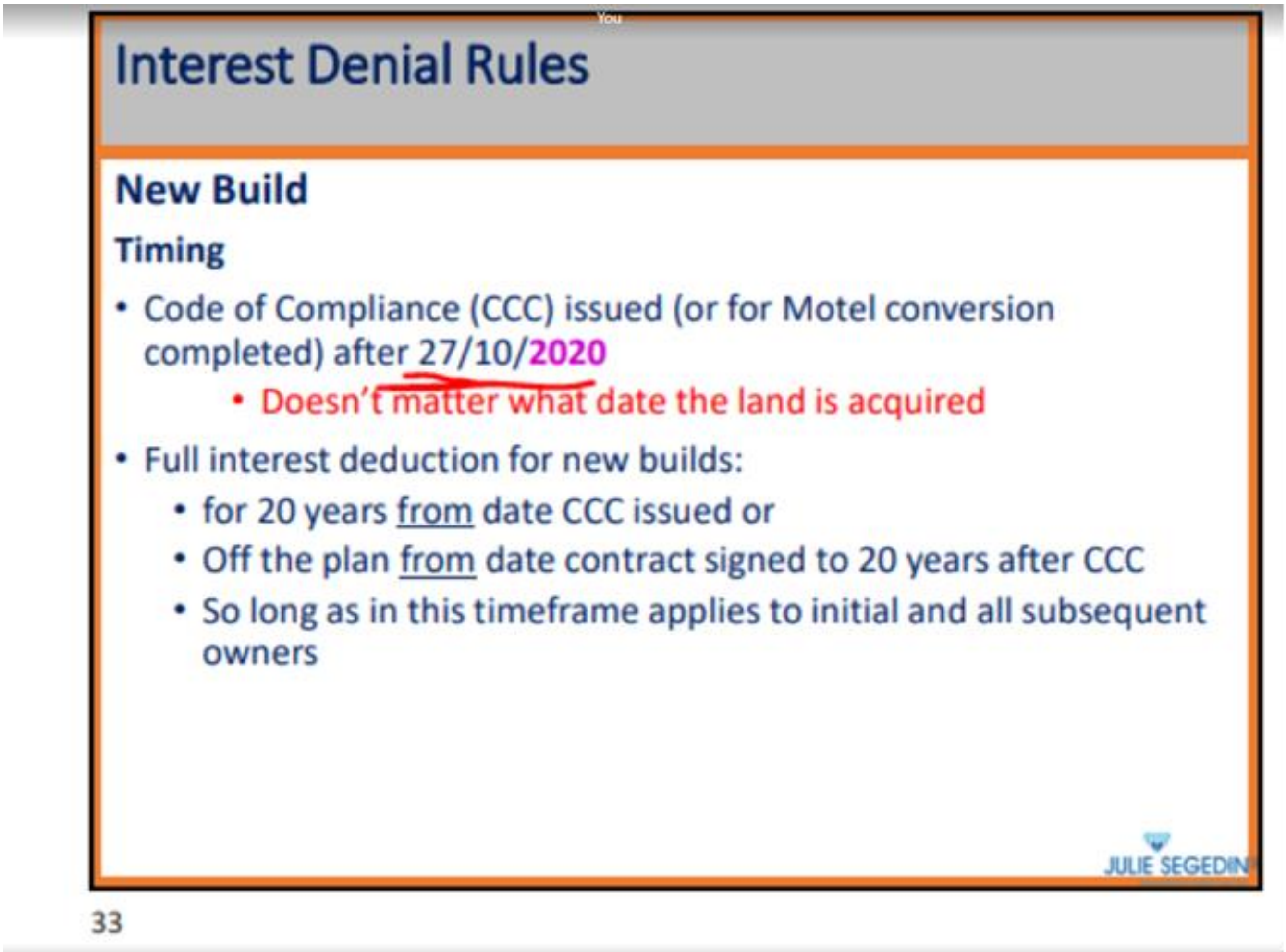
Q: Have you got a template for wording on an excluded dividend?

A: It is just the standard dividend resolutions and solvency certificates that you use for an ordinary company. All you have to do is delete the reference to imputation credits and RWT. For the dividend statements you just show the amount and somewhere on there put "LTC EXCLUDED DIVIDEND – NOT TAXABLE"

Q: Who can do a RPA - must go through lawyers?

A: Yes, only lawyers can prepare an RPA otherwise it won't meet the criteria in the Property (Relationships) Act 1976. An if it doesn't meet the legal criteria, it won't qualify as a relationship agreement for tax purposes (which means you won't get the rollover relief).

Error in slide. Please see slide below – somehow I managed to pick up the wrong date, It should read 27/**3/**20.



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