Residential Property - the bright-line test and tax

Are you thinking of buying or selling property? Consider the tax implications and plan accordingly.

Bright-line test

<table>
<tr><td>What it is</td><td>The ‘bright-line test’ determines whether tax should be paid on capital gain from the sale of residential investment property (with some exemptions).</td></tr>
<tr><td>Background</td><td>The bright-line test was introduced to apply where a person purchased a residential property on or after 1 October 2015 and sold it within two years.

In 2018 it was extended to five years, with effect from 29 March 2018.

In 2021 it was extended to ten years, with effect from 27 March 2021.</td></tr>
<tr><td>When it applies</td><td>The five-year bright-line test continues to apply to residential land if a taxpayer acquired an interest in the land on or after 29 March 2018, but before 27 March 2021.

If a taxpayer acquired an interest in residential property on or after 29 March 2018, but before 27 March 2021, and sells it within a five-year period, the sale will be taxed (with some exemptions).

If a taxpayer acquires an interest in residential property on or after 27 March 2021 and sells it within a ten-year period, the sale will be taxed (with some exemptions).

If a taxpayer acquires an interest in residential property on or after 27 March 2021 and the property qualifies as a ‘new build’, the ‘new build bright-line test’ will be based on a five-year period. Note this ‘new build bright-line’ test is currently before parliament in proposed legislation, but is expected to be introduced.</td></tr>
<tr><td>Exceptions</td><td>The sale will be not taxed if the property is the seller’s main home for all or almost all the entire period of ownership, inherited from a deceased estate, or transferred as part of a relationship property settlement.

The bright-line test does not apply to business premises or farmland.</td></tr>
<tr><td>Start / end dates</td><td>How the start and end date of the bright-line test is counted varies with what type of sale and purchase it is.
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<tr><td>Standard purchases</td><td>The start date will be the date a person obtains registered title for the property.

The end date will be the date of entry into agreement for sale.</td></tr>
<tr><td>Exceptions</td><td>Start and end dates are calculated differently where the registration date may not take place immediately or be the definitive point of transfer.

Examples are sales off the plan, sales of subdivided land, mortgagee sales or where property is gifted to a trust.</td></tr>
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Bright-line test and the ‘main home’

Inherited properties and those which have been the owner's main home for the entire time they owned it will continue to be exempt from all bright-line tests.

Main home?	Where the seller has more than one home, their ‘main home’ is the property with which they have the greatest connection.
Except	A vendor would not be able to use the main home exception if they have already used it twice in the previous two years immediately before sale.
What about Trusts?	If a trust owns the property being sold, the main home exception will apply when it’s the main home of a beneficiary of the trust.
Except	If the principal settlor of the trust has a main home that the trust doesn’t own, the main home exception cannot apply to any property owned by the trust.

For property acquired on or after 27 March 2021, including new builds, there is a ‘change of use’ rule and properties used as the main home may be taxable on sale. If the property has not been used as a main home for a period of more than 12 months, the tax payable on the profit is proportionate to the time the property was NOT the vendor’s main home.

If the property was not the owner’s main home for a period of 12 months or less during the whole period of ownership the main home tax exemption still stands.

Short-stay Accommodation

Residential properties used to provide short-stay accommodation, where the owner does not live in the property, will be subject to the bright-line test and cannot be excluded as business premises.

Companies and trusts

Inland Revenue keeps a close eye on where land-rich companies and trusts try to get round the bright-line test. They may view a transaction as subject to the bright-line test where:

- 50% or more of the shares within a 12-month period are sold
- there is a change in the trust deed
- a decision-maker under the trust deed changes

This applies where at least 50% of the value of the company or trust is attributable to residential land either directly or indirectly.

Claiming losses

Some deductions are allowable when a property subject to the bright-line test is sold. However, where losses arise because of the bright-line test, they have been ring-fenced. This means they may only be offset against taxable gains arising on other land sales. It is not possible to claim a loss arising from a transfer of property to an associated person.

The business continuity test (BCT) allows a company to carry forward tax losses to future years if they have a change in ownership if there is no major change to the company’s business activities. For companies relying on the BCT that have a breach of business continuity, under proposed rules currently being considered by Parliament, tax losses incurred in earlier years may be offset against a profit for the pre-breach part-year.

Claiming interest

From 1 October 2021, investors who acquired residential investment property on or after 27 March 2021 will not be able to claim the mortgage interest. Interest deductions for residential investment property acquired before 27 March 2021 will be phased out over the next four income years.

There are certain exemptions and exceptions to these interest limitation rules, including the main home, among others. Property developers can continue to deduct interest expenses and new build properties are also exempt. The fine detail is outlined in proposed rules currently being considered by Parliament. We'll keep you informed.

IRD numbers for property sales

All vendors and purchasers of property other than their main home must now provide an IRD number as part of the land transfer process. From 1 January 2020, this requirement applies generally and those buying or selling a main home must also provide an IRD number.

Non-residents	Offshore buyers may be required to provide a New Zealand bank account number before they can obtain a New Zealand IRD number. All non-resident buyers and sellers must provide their tax identification number from their home country, along with current identification requirements such as a passport.
Family trusts	A family trust is not exempt from providing an IRD number where a family's main home is owned by the trust. When the family home is transferred into the trust or when the trust buys or sells property, operates a business, or owns rental properties, the trust needs an IRD number. Trustees' own personal IRD numbers aren't acceptable. The requirements also affect changes of title. If a trustee dies or retires and the new trustee's name needs to be registered on the property title, the trust needs an IRD number to register the change.

Residential Land Withholding Tax (RLWT)

Where a vendor is an 'Offshore RLWT person', a withholding tax may be required to be deducted from the sales proceeds and paid to Inland Revenue where property is subject to the bright-line test. An offshore RLWT person is defined widely and captures owners of property that may appear to be in New Zealand, for example New Zealand registered companies whose majority directors are New Zealand based (but have 1 or more directors based overseas). A certificate of exemption may be applied for if certain criteria are met.

From 1 April 2021, the RLWT rate increases to 39% and applies to residential land sales by offshore persons within the bright-line period, except where the vendor is a company.

Keep in mind

This is a rapidly changing area. The proposals on interest limitation are being considered by Parliament and may change. Further areas are currently out for consultation.

Inland Revenue now issue bright-line campaign letters. As soon as they are aware of a potential bright-line transaction, usually within a month of the transaction, they send these letters to give an early heads-up of any possible tax obligations.

Please contact us if:

- you are considering buying or selling residential property
- you want to discuss whether the changes affect your tax profile or investment strategy
- your company is thinking about a large-scale share transfer
- there are any changes to your family trust's trust deed or trustees
- you are arranging for the family trust to buy, sell or transfer property, and the trust does not already have an IRD number; we can take care of this for you to help you avoid costly and stressful delays while you sort out the paperwork