



**Don't cut your cake before it's 10 years old**

The rampant increase in land values during the past few years has created a few goldmines for those carving up and selling land. Historically the IRD has paid little attention to this area, but that's likely to change, so it would be wise to consider the question of tax liability before IRD does. The following is a brief overview on some of the more relevant rules in relation to developing and dividing land.

Basically if you haven't purchased land to sell for a profit, the longer you hold it the better your position



is from a tax point of view. If that period is more than 10 years, the profit on the sale will only be taxable in limited circumstances. The 10 year period doesn't start from when the property purchase settles, it runs from the date the agreement goes unconditional.

Income Tax legislation may capture profits from "an undertaking or scheme . . . begun within 10 years". If the land has been held for less than 10 years, the time, money and effort put into carrying out the subdivision will determine if the profit is taxable. If the work required to complete the subdivision is "minor", the profit won't be taxable. If it is not minor, in other words "more than minor", the profit will be taxable. The use of the word "minor" in the tax legislation causes a few problems for the average person and tax specialists alike as it is subjective. What you might consider "minor", the IRD might consider "more than minor". Case law is used

as a guide, but there hasn't been a court case in recent years involving the modern trend of subdividing farmland into 3-5 sections. Every case is unique and the answer depends on its own facts, so the prudent person would get some advice from a tax professional on their proposed plan. If you decide that waiting until the 10 year period has passed is the answer, you need to be careful that you don't "commence" the subdivision before the ten year period runs out, as it will still be taxable. Deciding when a subdivision commenced is also tricky, so it is best to do nothing if you can wait.

If the land has been held for more than 10 years, the scheme can't be what is referred to as a "major development", if it is to remain non-taxable. Major developments refer to the types of subdivisions you find on the edge of most cities, where the residential housing is slowly devouring neighbouring rural land. This level of subdivision will often require roading, contouring, footpaths, streetlights and drainage. As a further sting in the tail, you may encounter an unexpected tax bill if

**"Things turn out best for people who make the best out of the way things turn out"**

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you sell land within 10 years of acquisition, even if you have not subdivided it. If you sell your land at a profit, and at least 20% of that profit arises because of a change (or the likelihood of a change of a legal nature to the land), some of the profit may be taxable. The types of changes include a zoning change, or a change

in respect of the land made under the Resource Management Act. However, the taxable profit is reduced depending on the number of years it has been held, at the rate of 10% per year.

If the proceeds of a land sale are taxable for any of the reasons

discussed above, there are exclusions that may apply. But that's another story.

***“The pessimist see difficulty in every opportunity. The optimist sees opportunity in every difficulty”***

## Do It Once - Do It Right

In July 2006 the government released a discussion document reviewing New Zealand's business tax system. The document is one of the products of the confidence and supply agreement between United Future, New Zealand First and Labour Parties. United's Peter Dunne, has called it a substantial commitment of tax policy resources and a thorough review of business taxation. The stated objectives of the proposals are to provide businesses with better incentives for productivity gains and improved competitiveness with Australia, and to transform the New Zealand economy into one with higher levels of business investment, innovation and skills. These stated objectives provide the context for the proposals in the document.

An outline of some of the proposals in the document follows. The approach of the review is to outline a number of different options, which will be narrowed down before a final select few are implemented. The initial options outlined are:

- Reduction in the company tax rate from 33% to 30%.
- Targeted tax credits in the areas of research & development, export market development and skills improvement.
- Deferral of certain types of research and development

expenditure.

- Allowing deductions for some “blackhole” expenditure, such as feasibility costs.
- Changes to depreciation loading percentages for new assets and possible application to second-hand assets.
- Increasing the low value asset write-off threshold from \$500 to \$1,000.
- Allowing asset write-offs when they have depreciated to a particular tax book value.
- Allowing more taxpayers to file their FBT returns annually.

The intention of this article is not to analyse in detail the various proposals outlined above. However, the general reaction to the overall document is that it does not cover enough business issues. This was meant to be a thorough review of the business tax system; therefore one would expect proposed changes at a more fundamental level. However, a large number of the proposals are merely tweaking and fine tuning the existing law (e.g. the low value asset threshold and filing FBT annually). These types of provisions should already be reviewed on a regular basis.

With respect to fundamental changes such as lowering the company tax

rate, considerable focus was put on explaining why a larger cut to the company tax rate was not possible. Reasons given include the fiscal impact of a deeper rate cut and the resulting pressure on the tax system due to the differences between the various tax rates. The government has indicated that deeper company rate cuts would need to be funded from either more payroll type taxes or an increase in the GST rate. It was decided that neither was acceptable.

A review of the company tax rate, in isolation from other tax rates for individuals and trusts, is considered by many tax professionals as a dangerous route. At the recent NZICA tax conference some tax professionals also expressed concerns at the prospect of the reintroduction of tax credits which saw a near collapse of the tax system in the early 1980s.

Although the Business Tax Review Document was intended to be a catalyst for the New Zealand economy to be more productive and competitive, there are significant issues that have not been addressed in the document. Given the potential impact of the proposed legislation on the economy, the approach should have been to do it once – do it right.

## IRD Default Assessments

The case of *Allen v CIR* recently decided by the Supreme Court is a scary wake up call to both taxpayers and their agents regarding default assessments issued by the IRD. Default assessments are often issued when a taxpayer hasn't filed a return on time.

In this case, the taxpayer failed to file income tax returns for the 2000 and 2001 years. The IRD issued default assessments and notified the taxpayer on 8 April 2002. The taxpayer had two months, until 7 June 2002, to invoke the statutory disputes procedure. On 15 July 2002 he filed a notice of claim in the

Taxation Review Authority (TRA) challenging the default assessments. On 31 July he furnished income tax returns for the two years showing his income as nil. On that same date he issued a Notice Of Proposed Adjustment (NOPA) to the IRD disputing each assessment. The notice of claim was eventually struck out because the taxpayer had not filed his return and issued the NOPA to the IRD by 7 June 2002. Basically the taxpayer had missed the window of opportunity to dispute the default assessments.

The legislation has been amended effective 1 April 2005 to allow an

increased period of four months to respond, not two months, in this type of situation. However, this case serves as a warning that once a default assessment is issued by the IRD you have to respond with some urgency to ensure you are not left with a tax bill that you can't dispute. The IRD does have the option of accepting a return outside the four month response period but the choice is essentially theirs. To be certain you will have the option to dispute a default assessment, a return and a NOPA should be filed with the IRD within the four month response period.

## Depreciation of your Rental - How far can you go?

Residential rental properties are acquired for various reasons. But if a rental property makes a loss, one of the advantages lies in the ability to offset that loss against other income, thereby reducing your overall tax bill. In order to maximise the loss without incurring extra costs, a practice developed in the late nineties of separating a house into its component parts and depreciating them separately. The depreciation deduction is increased because the IRD depreciation rates for building components are higher than the rate for a building as a whole. Further, these items do not generally increase in value so this could be a permanent tax saving.

The IRD has clarified its position on this practice. The IRD "considers it is unacceptable for residential property owners" to separately depreciate items that form part of the building, such as internal walls, doors, electrical wiring and plumbing as these are part of the building.



Items that are permanently attached and regarded as part of the building are also unable to be separated. These include kitchen cupboards, bathroom vanities and built-in wardrobes.

The IRD is not requiring taxpayers who have depreciated a residential rental property in this manner to reverse any of their previous depreciation claims. However, IRD is requiring the book value of these components to be added

to the book value of the building and depreciated along with the building from now on. IRD has not specified the particular income year for this to apply. What this means is

that IRD expects property owners to adopt this approach for the next tax return that is due to be filed.

Chattels such as carpets, drapes, whiteware and separately identifiable assets such as water heaters may continue to be depreciated separately.

Technically the issue is not clear, as the tax legislation does not prohibit the practice, and the rates available for the various components are provided by the IRD. However, given that the IRD has issued its stance on the matter, to continue to depreciate building components separately is tantamount to buying a fight with the IRD. It is then up to the taxpayer to decide whether or not they want that fight.

If a taxpayer's depreciation claim is significant, a dispute with the IRD could occur. However, a judge's interpretation of the scheme and purpose of the section may not fall in the taxpayer's favour.

## Generosity Can Cost

Relationships between shareholders in a company can be very complex and similar to personal relationships can require sacrifice. There may be instances where a dividend is declared by a company but a shareholder waives their right to receive it. This could be due to a number of reasons, for example, the

shareholders do not contribute equally toward running the company.

A problem that is often overlooked in this situation is that the waiving of the right to the dividend will constitute a gift, and depending on the amount, may be subject to gift

duty. In this case it would be the shareholder who is waiving the dividend and may be subject to gift duty.

**“You are as successful as you make up your mind to be”**



## Death and No Taxes

A will and any subsequent codicil (an additional document to an existing will) are normally drafted to ensure that assets are distributed in accordance with a person's wishes. Asset transfers often trigger tax consequences, and asset transfers on death are no different. The administration of a person's estate will result in two asset transfers. The first transfer is from the deceased person to the executor or administrator of the will and the second to the beneficiary or beneficiaries under the will. An income tax return is completed to the date of death to crystallise the deceased's tax liability. Historically, this has been a difficult area as the Act was inconsistent and at times unclear when it came to how to treat such asset transfers. For example, where a rental property was held by the deceased, a disposition at market value was required to be recognised resulting in depreciation recovered. But in the hands of the beneficiary depreciation could not be claimed as there was no acquisition cost.

Since 1 October 2005 the value of the asset transferred on death has been clearly prescribed. Such assets

must be transferred at market value. This general rule is modified depending on the circumstances.

For example, if all assets that were in the tax net pass to a spouse or de facto partner or another person who is a relative within the second degree of relationship, those assets can be transferred at their tax book value to the estate, then ultimately to the spouse or de facto partner. If assets in the tax net are distributed to a relative within the second degree of relationship or a charity, the initial transfer to the estate has to be at market value but the subsequent transfer to the beneficiary may be at the estate's book value. In addition, the will must not create a life interest or a Trust and all income earned by the estate must be distributed.

The new rules need to be carefully considered as there may be unintended consequences. For example, in your will you leave your wife a rental property and your son the remaining cash after all of your liabilities have been paid. At present your cash reserves are \$300,000. The will may have been drafted with the expectation that the transfer of the rental property will result in

depreciation recovered and a tax liability of \$100,000, leaving cash of \$200,000 for your son. Because of the new rules, the rental property will transfer at book value, and no tax liability for depreciation recovery will arise. The problem here is that the depreciation claimed on the property is now deemed to have been claimed by your spouse. If your spouse chose to sell the property the following year, she would have depreciation recovery income with tax to pay of more than \$100,000 which may have to come out of the sale proceeds. Regardless of how happy your son is with \$300,000, this is probably not the result you intended.

*If you have any questions about the newsletter items please contact us, we're here to help.*



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