Tax Alert

A focus on topical tax issues – February 2015

Consultation on the land development and subdivision provisions

By Phil Stevenson and Aran Bailey

Late last year, Inland Revenue released two exposure drafts relating to land subdivisions and developments. These were

- QWB0100: *Income Tax – Major development or division – what is 'significant expenditure' for section CB 13 purposes,* and
- QWB0040: *Income Tax – Whether it is possible that the disposal of land that is part of an undertaking or scheme involving development or division will not give rise to income, even if no exclusion applies*

What is significant expenditure for major subdivisions?

The draft statement QWB0100 provides some much needed guidance on what type and what level of expenditure could trigger the land taxing provision applying for major subdivisions, section CB 13 of the Income Tax Act 2007 ("the Act").

Section CB 13 applies in circumstances where the disposal of land is not otherwise taxable under the Act, and there is an undertaking or scheme involving development or division of land where the work "involves significant expenditure on channelling, >>

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contouring, drainage, earthworks, kerbing, levelling, roading or any other amenity, services or work customarily undertaken" in major projects involving the development of land (emphasis added).

The primary conclusion in the exposure draft is that the relevant expenditure relating to "any other amenity, service, or work customarily undertaken or provided in major projects" should be interpreted in a limited manner so that only physical development work is included. Expenditure that relates only to division activities (rather than physical development) is not relevant for assessing whether the level of expenditure is significant expenditure for the purposes of section CB 13. An example of this type of expenditure is surveying costs relating to the division (preparation and deposit of plans) as opposed to surveying for the development of the land.

Some other useful conclusions reached by the Department in the exposure draft include:

- Whether expenditure on the undertaking or scheme is significant will be a matter of fact and degree in the circumstances of any given case. The relevant factors listed in the draft are the amount of the expenditure in absolute terms, the amount of the expenditure relative to the pre and post development value of the land, and the context of the project.

- Proceeds from a disposal of land in a major subdivision will only become taxable under section CB 13 once there has been significant expenditure incurred. This will have relevance in situations where a development project is undertaken in a staged manner (i.e. where some lots are able to be divided and sold off prior to the significant expenditure on earthworks occurring).

- Confirmation that section CB 13 is intended to only cover major, large scale, subdivision projects. It is possible to incur significant expenditure, in both absolute and relative terms, and not trigger the provision. An example of this could be where major retaining and drainage work is required due to the technical difficulty of the work or unique circumstances of a particular development. However, where the number of lots in the project is limited, the proceeds from the sale of land should not be taxable under section CB 13 of the Act.

- The use of a person's time, effort and their own machinery does not need to be taken into account in assessing the level of expenditure for the purposes of section CB 13.

The statement attempts to provide some guidance on the level of expenditure that could trigger the application of section CB 13. However, as is common with examples provided by Inland Revenue, the factual situations presented in the example lead to answers that are clearly on one side or the other. Usually when practitioners are advising on these situations the facts are not as "neat" as those presented in the limited examples, resulting in more border line positions. To complicate matters even more there is limited guidance available for advisors and taxpayers from court decisions.

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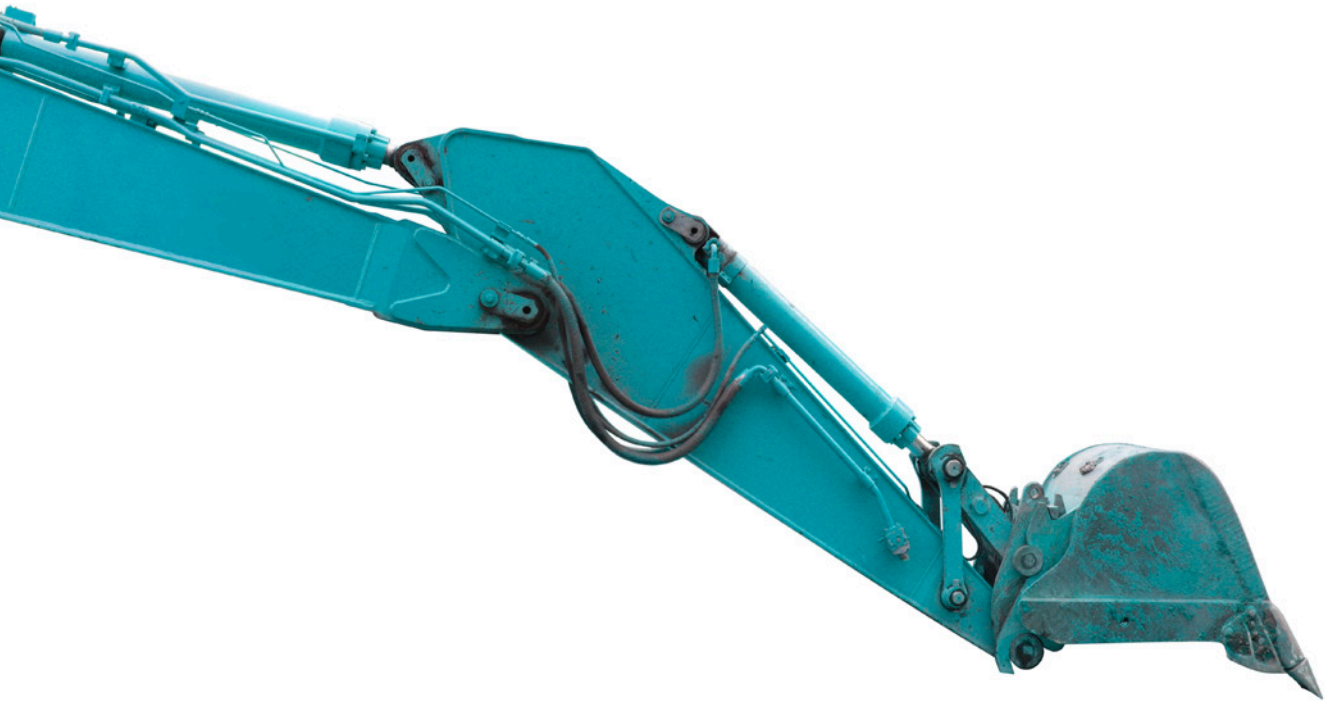

Section CB 12 of the Act applies to schemes at the other end of the subdivision scale, being those commenced within 10 years of acquiring the land where the work is **work that is more than minor** in nature.

All of the cases that have been decided by the courts in relation to the predecessors to sections CB 12 or CB 13 are at least 20 to 30 years old and the minimum resource consent standards and requirements have changed significantly over this time. In order to get any value from these cases and try to pin-point the relevant expenditure boundary it is necessary to adjust the amounts incurred in those cases into present day dollars and apply some judgment over the complexity of the development or division work completed.

What would be of greater assistance to taxpayers in determining their liabilities, rather than the limited examples presented in the exposure draft, is for the (appropriately redacted) decisions of Inland Revenue's Disputes Review (previously Adjudication) Unit to be made available to the public and/or tax agents.

In disputes with Inland Revenue relating to subdivisions, it is common for taxpayers to have strong arguments but be unable to fully test those arguments due to the costs of proceeding with a dispute compared to the potential tax payable. Where a dispute does make it to the adjudication phase of the disputes process the outcome is not made available to other taxpayers to help them assess their own tax positions.

It would not be difficult to remove any identifying comments from the Disputes Review Unit's decisions and make these available whilst still protecting individual taxpayer's privacy. Any internal costs for the Department would be outweighed by the benefits to taxpayers generally from the greater transparency.

Is it possible that the disposal of land that is part of an undertaking or scheme involving development or division will not give rise to income, even if no exclusion applies?

QWB0040 is a re-released draft of an earlier draft item issued by the Department in 2012. The Department is seeking further consultation given the length of time since the original draft item and because the Commissioner's analysis has changed slightly.

The situations where this statement will be relevant are where a division or development is carried on and the disposal of land would be taxable under section CB 12 or CB 13 of the Act. For example, a block of land is purchased and immediately divided into four lots with two lots being sold and two lots being retained for the taxpayer's own use.

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Where the retained lots are subsequently sold it is necessary to determine if the sale proceeds will be taxable. The lot is part of an undertaking or scheme of division, commenced within 10 years of acquiring it. Assuming the work was more than work of a minor nature the disposal proceeds would prima facie be taxable. In practice, there are a number of residential, investment, farming and business exclusions that are often available where land is retained. However, there are often situations where these exclusions cannot be applied.

The conclusion in the exposure draft is taxpayer friendly and unlikely to draw much criticism

The exposure draft concludes that where part of the land (the lot now being disposed of) was not part of an undertaking or scheme of development or division carried on with a **view to the disposal of that part of the land**, the disposal proceeds will not be taxable. Inland Revenue will expect to see evidence that there was some other plan for that land and the draft provides some comments on the type of evidence they will be looking for.

This exposure draft is a vast improvement on the earlier 2012 draft item. The analysis and reasoning is more logical. In our opinion, some of the interpretations in the earlier draft "drew a long bow" and were focused on achieving a desired outcome rather than being a logical interpretation of the Act.

The conclusions reached in the current draft do however arguably strain the interpretation of the actual words in sections CB 12 and CB 13 of the Act. On the words alone, a subsequent disposal of a portion of land retained from an undertaking or scheme caught by these provisions will be taxable regardless of when the disposal takes place or what the retained land was used for (subject of course to any available exclusions). The Commissioner has sought to determine the intended scope of the original land taxing provisions for developments and divisions and, having determined that the intent was to focus only on development and division schemes where disposal of the land was in mind, the Commissioner has effectively inserted an additional requirement into sections CB 12 and CB 13 which is not present in the legislation.

The conclusion is of course taxpayer-friendly and, despite our comments above, is unlikely to draw much criticism during the consultation process. Arguably it presents a purposive interpretation of the relevant rules and could be acceptable on that basis.

There is however a need for some caution. Some of the analysis is not so beneficial for taxpayers. The Department expresses the view that it is only necessary that an undertaking or scheme be **carried on** to trigger section CB 12 or CB 13. It is not necessary for the undertaking or scheme to have been **carried out** (i.e. completed). This could lead to a situation where the sale of land forming part of an abandoned project could potentially be subject to taxation. This is the case even if no development work is actually undertaken and no ultimate division of the land occurs. The question will then be, did an undertaking or scheme commence? This is a difficult question in its own right.

Changing depreciation rates – when is it acceptable?

Inland Revenue recently released a draft Question We've Been Asked (QWBA), QWB0131: *Income Tax – Changing to a different depreciation rate for an item of depreciable property.* This draft focuses on situations where a taxpayer who is already using a depreciation rate for an item of depreciable property can change that depreciation rate.

The correct approach for choosing depreciation rates at the outset is often misunderstood. The depreciation rules require a taxpayer to use the depreciation rate that applies to their item of depreciable property. In the Commissioner's view, the Income Tax Act 2007 contemplates only one depreciation rate applying to the item. In other words, taxpayers can't simply choose a more beneficial rate if it seems that more than one asset class "may fit" an item. It is a matter of correctly identifying their item and then finding the item description that "most accurately describes" the item of depreciable property. The correct approach is to look at the asset class descriptions in the industry and asset categories in the Table of Depreciation Rates.

Generally if there is an asset class description (other than a default class) in the appropriate industry category that applies to the item, the depreciation rate for that asset will be the applicable rate and there is no need to look at the asset categories.

The QWBA considers five instances where the depreciation rate that a taxpayer uses in respect of an item of depreciable property can be changed:

1. There is a change in legislation that means a different depreciation rate applies to the item.
2. The taxpayer changes from using a special rate to using the economic rate or provisional rate that applies to them.
3. The Commissioner sets a new depreciation rate that applies to the item of depreciable property.
4. The taxpayer has been using an incorrect depreciation rate.
5. The depreciation rate is no longer applicable due to a change in circumstances.

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Once it is established that a taxpayer is required to change their depreciation rate, the issue then becomes when the new rate will apply from. The draft states that, depending on the circumstances leading to the rate change, the change may be prospective or retrospective.

Most of the circumstances covered by the QWBA will have a prospective application once the change is made. The exception is the circumstance where the taxpayer has been using an incorrect rate. The statement notes that if a taxpayer has used an incorrect depreciation rate, they are required to change to the correct applicable rate. In this situation, the taxpayer will be required to follow the usual procedures provided in the Tax Administration Act (TAA) for the correction of errors:

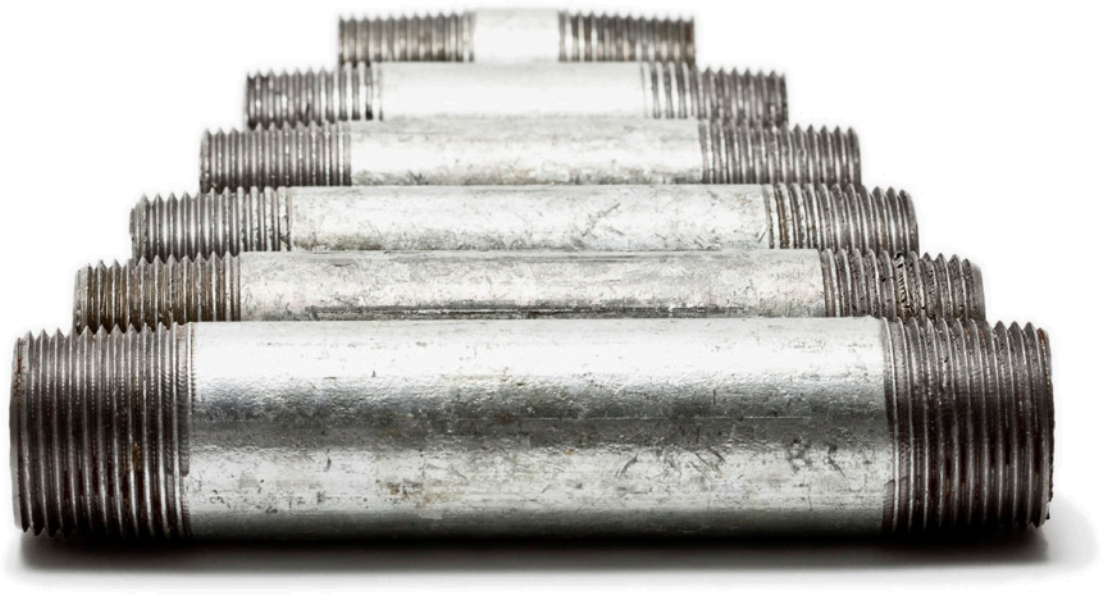
- Section 113A of the TAA provides for the correction of minor errors in subsequent returns. For example, if the net tax effect of using the wrong depreciation rate is $500 or less for each income year, the errors can be corrected in the current income tax return with fixed asset schedule adjusted accordingly.
- If the requirements of section 113A are not met, the taxpayer can make a voluntary disclosure or make an application to the Commissioner under section 113 of the TAA where the Commissioner has discretion to amend assessments to ensure correctness.

The QWBA confirms that "using an incorrect depreciation rate" includes where a taxpayer does not use the rate for the asset class that most accurately describes the depreciable property – specifically this can include where the more accurate rate is more beneficial (e.g. a specific rather than default class rate) than a current (but arguably applicable) rate.

Overall, the statement provides useful guidance and the examples are practically relevant for most situations that will commonly arise in this regard.

Submissions close on this draft on 20 February 2015. For further information about this item please contact your usual Deloitte advisor.

If the taxpayer has used an incorrect depreciation rate, they are required to change to the correct applicable rate



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High Court provides guidance on contractual interpretation and a taxpayer win on shortfall penalties

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By Emma Marr and Jesse Pene

The High Court recently delivered its judgment in *C of IR v John Curtis Developments Ltd* [2014] NZHC 3034. This case provides useful guidance on the capital/revenue boundary, interpreting contractual arrangements and some further elaboration on the application of the "unacceptable tax position" shortfall penalty. Although the taxpayer did not succeed on the substantive tax issue, the judgment provides a refreshing view for the taxpayer on shortfall penalties.

Background

In 2000, the taxpayer, a property developer, started developing a retail shopping centre north of Christchurch with the intention of leasing units to retailers. After four years, the project was 65 per cent complete and the taxpayer sold the centre (comprising the developed part of the centre and the undeveloped land) to a third party, AMP. The sale agreement included an "option" that required the taxpayer to use best endeavours to lease and build the undeveloped part of the centre. In return, the taxpayer received "development payments" from AMP.

The main issue for determination was whether the agreement provided for a single supply of a capital asset, or two distinct supplies – one capital (sale of the developed centre and the undeveloped land) and the other revenue (letting and construction services on the undeveloped land). There was $2,615,574 of tax and $261,557 of shortfall penalties at stake. The Commissioner had already accepted that the developed centre and undeveloped land was a capital asset developed for the purpose of holding as a long term investment, and therefore the payment received for the existing buildings and land was not taxable.

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The taxpayer claimed that both the purchase price for the land and centre and the development payments were capital receipts, and therefore not taxable. It was asserted that the agreement was for the sale of the completed shopping centre, and that the development option was simply a condition subsequent that the taxpayer had to comply with before AMP would pay the remainder of the purchase price.

The Commissioner argued that the development payments received by the taxpayer from 2006 to 2009 were assessable income (with receipts from earlier years being time-barred). The Commissioner maintained that there were two supplies from the taxpayer to AMP:

1. The sale of the partially completed shopping centre, including all the developed units and undeveloped land (sale of a capital asset and therefore receipts not taxable as income).

2. Development services to AMP of constructing buildings and supplying tenants for those buildings on land that was undeveloped at the time of sale (development payments that were taxable income to the taxpayer).

The dispute was first heard in the Taxation Review Authority (TRA) which found in favour of the taxpayer.

On the issue of whether there were two separate supplies, the TRA agreed with the taxpayer that there was a single contract for sale and purchase of the completed centre. The TRA found that the development option was not separate from the agreement for sale and purchase of the land and completed units. It was simply a "mechanism... for delivery of the completed centre".

On the basis that the agreement was for a single supply of the completed shopping centre, the TRA concluded that this was the supply of a capital asset. Accordingly, all consideration paid to the taxpayer under the agreement, including the development payments, was capital and not taxable. As a result, there was no further tax liability and no shortfall penalties were payable.

High Court decision

Preliminary issues

The Court addressed two preliminary points prior to considering the primary issue concerning interpretation of the agreement:

- The admissibility of certain evidence relating to the taxpayer's intention;

- Whether the Commissioner was entitled to rely on an argument that the taxpayer considered was not included in her Statement of Position (SOP).

On the first point, the TRA heard evidence from representatives of both parties (i.e. taxpayer and AMP) as to the intentions of the parties during pre-contractual negotiations, and the meaning and intent of the various provisions of the agreement. The Court agreed with the TRA that the evidence should be excluded, as it amounted to "subjective declarations of intent" that should not be taken into account when interpreting the contract.

On the second point, the taxpayer submitted that the Commissioner's grounds in the TRA impermissibly departed from her SOP in breach of the "issues and propositions of law exclusion rule" in section 138G of the Tax Administration Act 1994. It was argued that in her SOP, the Commissioner relied on there being two separate contracts, rather than a single contract to complete the whole development, whereas in the TRA and High Court, the Commissioner argued that there was one contract, but that there were two supplies under that contract. The Court considered the wording of section 138G and found that, while the Commissioner was limited to the "issues and propositions of law" disclosed in either her or the taxpayer's SOP, it was enough for this reference point to be an "outline" of those propositions of law, which was in enough detail to "fairly inform" the relevant other party. The Commissioner's SOP met this level of required detail, and in any case, the argument that there was a single contract was raised in the taxpayer's SOP, which in itself entitled the Commissioner to make that argument before the TRA and High Court. >>

Primary issue – one supply or two?

Justice Kos in the High Court overturned the TRA decision and concluded that the agreement contained two "distinct and separately identifiable supplies", one capital and one revenue. In summary, his Honour noted the following points in arriving at his decision:

a. It was clear the agreement encompassed two obligations – the sale of the existing land and development at the time of sale, and the future development services. It was not an agreement for a single supply of a completed development.

b. The payment of the two sums – the purchase price and the development payments – did not depend on one another. If the future development did not take place, there was no impact on the purchase price. AMP could have cancelled the development option, which supported the proposition that the two supplies were separate.

c. Failure to develop all of the remaining sites would not be a breach of the agreement, unless the taxpayer failed to use best endeavours to do so.

d. Once the taxpayer had sold the land to AMP, the nature of the work performed under the development option was services supplied to a third party. They no longer had the characteristic of capital improvements to the taxpayer's own land as the taxpayer no longer owned the land.

Having concluded that there were two supplies Justice Kos found that the development payments were taxable. His Honour ruled out any arguments suggesting that the payments were merely ancillary, noting that the further development payments were $26.6m, compared with the land and centre sale price of $31.28m.

The question then became, were the development payments business income? Justice Kos answered this in the affirmative. The taxpayer was in the business during the relevant period of finding tenants and constructing retail units. The activity was organised, coherent, and directed to making a profit. That profit was earned by receiving the development payments in the course of that business, and therefore the development payments were taxable income.

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Shortfall penalties

This case also provides useful guidance on the application of the shortfall penalty for an unacceptable tax position. The Commissioner argued that this shortfall penalty should apply because the taxpayer had taken an unacceptable tax position (i.e. the tax position failed to meet the standard of being "about as likely as not to be correct"). The Court emphasised that the test is objective, not subjective, and that the taxpayer's actual belief is irrelevant. If the taxpayer's argument "can objectively be said to be one that, while wrong, could be argued on rational grounds to be right' (citing the decision in *Walstern Pty Ltd v C of T* (2002) FCR 1), then the shortfall penalty for an unacceptable tax position will not apply.

Justice Kos took the view that since the TRA, in a "cogent and careful decision", upheld the taxpayer's argument, it was a tax position that a reasonable mind might adopt. On that basis shortfall penalties were not imposed.

Observations

So what are some key take-away messages from this case? The first point, and perhaps most obvious, is that parties to a contract need to carefully consider a transaction from a tax perspective. If the intention had been to simply sell a completed development, the parties could have drafted the agreement such that it explicitly provided for a single supply, payment and obligation, with one sale, and provisions to provide consequences for non-performance of post-completion development work. Recognising that each contract is unique, businesses should be liaising with their tax advisers to ensure that agreements are wholly consistent with and achieve the expected tax outcome.

The second observation relates to contractual interpretation. The Court reaffirmed that oral evidence relating to "subjective declarations of intent" is not admissible in interpreting a contract. The exercise of ascertaining intention is purely an objective one, which is another reason for parties to ensure that any agreement is drafted carefully such that it sufficiently accurately records and reflects the collective parties' intentions.

Finally, the judgment provides useful guidance on the standard for applying an unacceptable tax position shortfall penalty, in particular the meaning of "as likely as not to be correct". It is useful to re-confirm that an argument can ultimately be found to be wrong, but can still be sufficiently rational to meet the test. In this particular case, the fact that the TRA had found for the taxpayer was enough to establish that the taxpayer's argument could be argued on rational grounds to be right, and so the penalty did not apply.

BEPS - Keeping up-to-date via Dbriefs and BEPS Central

Since our last Tax Alert in December 2014, there has been quite a bit of activity in relation to the Base Erosion and Profits Shifting (BEPS) project with several further discussion drafts issued, an OECD progress update webcast and public consultation meetings held on the various action points. This activity will continue through to July this year.

In response, Deloitte has set up the **BEPS Central** site which is your one-stop shop for everything BEPS-related. Here you can find all the official documents on the BEPS project, as well as related Deloitte opinion and analysis.

Another way to keep up with what's happening in the BEPS world is to tune into the Deloitte Dbriefs.

Dbriefs are live online webcasts, aimed at an executive level audience, providing a discussion on relevant business topics which you can access from the comfort of your own office. Attending the live session will count towards CPD credits. Further, sessions are archived for up to 6 months. To access the schedule for January to March 2015 click **here**.

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