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WEEKLY COMMENT: FRIDAY 8 MAY 2015

1. This week and next week I look at two recently released Questions We've Been Asked on the taxation of land transactions:
 - (a) QB 15/02 *Income tax – Major development or division – what is “significant expenditure” for section CB 13 purposes?* released on 1 April 2015 and the accompanying *Commissioner’s operational position on what is “significant expenditure” for section CB 13 purposes* released on 15 April 2015, both of which are published in *Tax Information Bulletin* Vol. 27 No. 4, May 2015, pp. 20-29; and
 - (b) QB 15/04 *Income tax – Whether it is possible that the disposal of land that is part of an undertaking or scheme involving the development or division will not give rise to income, even if no exclusion applies* released on 13 April 2015 and published in *Tax Information Bulletin* Vol. 27 No. 4, May 2015, pp. 37-51.

QB 15/02

2. QB 15/02 is concerned with what expenditure is taken into account for s. CB 13 purposes, and when such expenditure would be regarded as “significant”.

Section CB 13

3. Section CB 13 is one of a number of provisions taxing amounts derived from disposing of land. It applies when the amounts are not taxable under any of sections CB 6 to CB 12 and CB 14. Therefore, it is first necessary to check whether any of these other provisions could apply before considering whether s. CB 13 applies.
4. An amount that a person derives from disposing of land will be income of the person under s. CB 13 if:
 - (a) An undertaking or scheme, which is not necessarily in the nature of a business, is carried on; and
 - (b) The undertaking or scheme involves the development of the land or the division of the land into lots; and
 - (c) The person, or another person for them, carries on development or division work on or relating to the land; and
 - (d) The development or division work involves significant expenditure on channelling, contouring, drainage, earthworks, kerbing, levelling, roading, or any other amenity, service, or work customarily undertaken or provided in major projects involving the development of land for commercial, industrial, or residential purposes.

5. This rule is overridden by the exclusions for residential land in s. CB 17, for business premises in s. CB 20, for farm land in s. CB 21, and for investment land in s. CB 23.
6. When a person derives income under s. CB 13, for the purpose of determining the amount of the deduction, the person is treated, under s. DB 27, as:
 - (a) Having disposed of the land to an unrelated third party immediately before the start of the undertaking or scheme; and
 - (b) Having reacquired it immediately after the start of the undertaking or scheme at the market value of the land at the time.
7. Therefore, the increase in the value of the land from the time the undertaking or scheme commenced until the land is disposed of is taxed.

The expenditure requirements of s. CB 13

8. Section CB 13 requires that the development or division work involves significant expenditure on channelling, contouring, drainage, earthworks, kerbing, levelling, roading, or any other amenity, service, or work customarily undertaken or provided in major projects involving the development of land for commercial, industrial, or residential purposes.
9. The discussion in QB 15/02 proceeds by first considering what types of expenditure are included, and then looking at when such expenditure would be regarded as “significant”.

Expenditure must be of the same class as the specifically listed works

10. The specifically listed works are channeling, contouring, drainage, earthworks, kerbing, leveling and roading.
11. Also included is “any other amenity, service, or work customarily undertaken or provided in major projects involving the development of land for commercial, industrial, or residential purposes”.
12. According to the discussion in QB 15/02 the *ejusdem generis* principle directs that if the specific words in the list are of the same class, the general word following them is construed as also being limited to that class. The requirements for the *ejusdem generis* principle to apply, as set out in *Skycity Auckland Ltd v The Gambling Commission* [2007] NZCA 407, are met.
13. The Commissioner’s views on how the *ejusdem generis* principle applies in this case are as follows:
 - (a) The listed works are “development” works as opposed to “division” works, therefore, purely division work should not be taken into account;
 - (b) “Development” in the context of s. CB 13 means development in the sense of preparation of the land for an intended use, therefore, it does not include the construction or erection of buildings;
 - (c) While the listed works are all physical works, the application of the *ejusdem generis* principle does not exclude non-physical work, providing that it is development work, and the reasons advanced to support this view are:
 - (i) Section CB 13 refers to “development or division work on *or relating to* the land”, which suggest that work other than work on the land should be included;

- (ii) Section CB 13 also refers to “service” provided, which suggests that non-physical development work should be included;
 - (d) Other (not listed) examples of physical development work are paving, retaining, sewage piping, power cabling, demolition and site clearing;
 - (e) Examples given of non-physical development work are preparation of a zoning application, the drawing of engineering plans and specifications and the provision of estimates;
 - (f) Examples given of purely division work that would be excluded are surveying that is related to the division of the land (as opposed to surveying related to the development of the land), and the preparation and deposit of subdivision, unit title or flat plans.
14. The Commissioner’s view is that the reference to “work customarily undertaken or provided in major projects” does not result in the exclusion of work that might also be undertaken in minor projects. The categories of work are not exclusive to major projects, and the distinguishing feature will be whether the expenditure is “significant – see paragraph 23 onwards below.
15. The Commissioner is also of the view that the work need not actually be undertaken in the context of a commercial, industrial or residential development. The requirement is that the work is of a type “customarily undertaken” in the context of such projects.

A person’s time, effort and use of their own machinery does not count

16. The Commissioner does not consider that a taxpayer’s (or other person’s) time, effort or use of their machinery or other equipment is a relevant consideration for s. CB 13 purposes. This contradicts the two decided cases on what is now s. CB 13:
- (a) *Aubrey v CIR* (1984) 6 NZTC 61,765 (HC), in which the judge noted that the expenditure of time and the use of machinery could not be quantified in monetary terms, but were nonetheless relevant; and
 - (b) *Mee v CIR* (1988) 10 NZTC 5,073 (HC), in which the judge made a monetary allowance (which equated to \$306) for the taxpayer’s time and the use of his machinery.
17. In the Commissioner’s view, “expenditure” in s. CB 13 should be read in the sense that it is generally used in taxing statutes – an outlay of a monetary sum. Therefore, actual expenditure on payments to working owners, working partners and others should be taken into account.
18. Similarly, actual expenditure incurred in relation to the use of machinery, such as the cost of fuel, expenditure on hiring machinery, and expenditure on the purchase of machinery is relevant. In the case of the purchase of machinery it may be appropriate to apportion the expenditure to reflect the use related to the undertaking or scheme.

Future expenditure not yet incurred does not count

19. Consistent with the use of the word “expenditure” in taxing statutes, the Commissioner considers that intended future expenditure should not be taken into account. Only expenditure incurred up to the point in time at which an amount is derived from the disposition of a particular piece of land is relevant.
20. While the wording of s. CB 13 does not make this clear, the predecessor provision in the *Income Tax Act 1994* referred to expenditure that had been incurred, and given that no policy change was intended, the meaning is carried forward to s. CB 13.

Expenditure must be incurred by or on behalf of the taxpayer

21. Following decision in *Mee*, the Commissioner considers that payment to the council for future roading, water and sewerage should not be taken into account because it would not be work "carried out by or on behalf of the taxpayer on or in relation to the land".
22. Other council contributions such as development contributions for additional community and network infrastructure would not be taken into account either, because such contributions typically go towards the cost of public infrastructure that is needed, and would not be work done on behalf of the taxpayer.

When expenditure will be "significant" for s. CB 13 purposes

23. The Commissioner notes that it is the totality of the expenditure that needs to "significant", and it is not necessary for expenditure on any given category to be "significant" on its own. Based on *Aubrey* and *Mee*, the Commissioner considers that whether expenditure is "significant" for s. CB 13 purposes will be a matter of fact and degree in the circumstances of any given case. The Commissioner has discussed these two cases and has also provided three examples.
24. The Commissioner considers that the nature and extent of the physical work carried out is not instructive in indicating whether the expenditure is significant.
25. The Commissioner has discussed the following relevant factors when deciding if expenditure is "significant":
 - (a) **The expenditure in absolute terms is a relevant consideration:** In *Aubrey*, expenditure of \$20,280 in 1967 and \$109,620 in 1983 were significant, whereas in *Mee*, expenditure of \$3,750 was not significant. It may be that expenditure in absolute terms is sufficiently high to be significant, even though in relative terms it would not seem significant. Example 3 provided by the Commissioner concerns expenditure totaling \$1.25m on land that, prior to development, was valued at approximately \$30m. Despite the expenditure being a very low proportion of the pre-development value, the amount of the expenditure is sufficiently substantial for the expenditure to be regarded as significant.
 - (b) **The expenditure in relative terms is a relevant consideration:** In *Aubrey*, 12% of the resulting value of the land was seen as a significant proportion, whereas in *Mee*, expenditure of 2% of the pre-development value was not significant. However, expenditure that might be significant in relative terms may well not be significant when considered in absolute terms and in the context of the project (see below).
 - (c) **The context can be informative as to how significant the expenditure is:** An example is given of someone having to deal with a particularly litigious party in the Environment Court as a result of which the development costs might be more than would otherwise be expected for a similar development project, which would be a relevant contextual consideration in assessing whether the overall expenditure is significant. Example 2 provided by the Commissioner concerns development costs of \$60,000 incurred on a residential subdivision of a front part of a section on which a flat was built and then sold. Despite the expenditure being 10.9% of the pre-development value of the property of \$550,000, it is not significant when considered in the context of the relatively modest project on a single residential block.
 - (d) **It is the amount of expenditure incurred up to the point in time an amount is derived from disposing of the land that is relevant:** Example 1 provided by the Commissioner

concerns progressive sales of subdivided lots. At the time the first 3 lots were sold, only \$10,000 had been incurred on earthworks. That was not regarded as significant in terms of s. CB 13. By the time the remaining 15 lots were sold, a further \$190,000 of expenditure on development work had been incurred. This was regarded as significant in relative and absolute terms with the result that s. CB 13 applied to the sales of the last 15 lots.

Commissioner's operational position

26. The Commissioner's Interpretation Guideline IG0010 "Work of a minor nature" published in *Tax Information Bulletin* Vol. 17 No. 1, February 2005 states that development work entails some form of physical work being undertaken in relation to the land. The Commissioner no longer considers that statement to be correct.
27. Therefore, the Commissioner has released *Commissioner's operational position on what is "significant expenditure" for section CB 13 purposes* setting out the following transitional operational position:
- (a) Expenditure on non-physical development work incurred before 1 April 2015 can be ignored for s. CB 13 purposes if the land is sold prior to 1 April 2017;
 - (b) Expenditure on non-physical development work incurred on or after 1 April 2015 must be taken into account;
 - (c) If the land is not sold by 31 March 2017, QB 15/02 will apply, with the result that all expenditure on no-physical development work pre- and post-1 April 2015 must be taken into account for s. CB 13 purposes.



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