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WEEKLY COMMENT: FRIDAY 24 JUNE 2022

1. Matariki seems like a good time to take a break from reviewing new legislation and, instead, look at a recent Interpretation Statement. On 14 June 2022, Inland Revenue issued Interpretation Statement IS 22/03 "Income tax – application of the land sale rules to changes in co-ownership, subdivisions, and changes of trustees", previously issued in September 2021 as draft interpretation statement PUB00411.

2. In the past few weeks, I have reviewed the new interest limitation rules and the additional bright-line test rules for residential properties. IS 22/03 concerns a related topic – co-ownership and the circumstances in which changes to co-ownership will be treated as disposals for tax purposes (resulting in exposure to the bright-line test for residential properties).

3. IS 22/03 addresses the question of whether changes in co-ownership, subdivisions, and changes of trustees involve a "disposal" of land. "Land" is defined in s YA 1 as including any estate or interest in land. The disposal of any estate or interest in land is, therefore, within the scope of the land sales rules.

4. Consequently, the question of whether there is a "disposal" in these situations is key to whether a tax liability may arise. IS 22/03 also discusses when the Bright-line 'clock' starts in these situations.

5. Inland Revenue notes that often, an actual "amount" will not be derived from these transactions. However, if there is a "disposal", and it is for less than market value consideration, the person may be deemed, under s GC 1, to have derived the market value at the time of disposal, with the possibility of income, regardless of whether an actual amount was derived or not.

6. The examples in IS 22/03 involve transfers of title to the legal estate. However, the conclusions are also applicable to transfers of equitable interests in land.

7. IS 22/03 concludes that the ordinary meaning, case law and legislative history and context, indicate that "disposal" in the land sale rules:

   (a) Requires complete alienation of the land by the disposer – the land must be 'got rid of' by the person (though this does not mean there could not be a deemed disposal applying the *Sharkey (Inspector of Taxes) v Wernher* (1955) TC 36 (HL) principle);

   (b) Requires dealing with the land – so that one person loses ownership of the land and another (which would include the same person in a different capacity) gains it (or gains a corresponding interest in respect of the same underlying land) – *Case M4* (1990) 12

NZTC 2,021 (TRA) suggests that 'disposition' in the land sales rules requires property passing to someone;

(c) *Paul Stephens Construction Ltd v CIR* (1990) 12 NZTC 7,192 (HC) lends some implicit support to the view that while a subdivision of land involves the cancellation of the prior title(s) and the issue of new titles, this does not result in a new 'acquisition' for the purposes of the land sale rules and so therefore also cannot be said to involve a 'disposition' for those purposes;

(d) Does not include extinguishment or the ceasing to exist of an interest in land.

8. Therefore, in the Commissioner's view, "disposal" in the land sale rules does not include:

(a) Transfers to self (in the same capacity) – although, as noted above, this does not mean that there could not be a deemed disposal applying the *Sharkey v Wernher* principle, however, Inland Revenue considers that this will not apply in all cases – for example, under s CB 6 intention is assessed at acquisition and a change of intention will not take the land out of the tax base);

(b) Extinguishment of an estate or interest in land to the extent that does not result in some other person acquiring an interest that corresponds (in whole or in part) to the extinguished interest.

9. The Commissioner notes that s 56 of the *Property Law Act 2007* states a person may dispose of property to themselves, and, under the Torrens title system a legal interest in land is created or transferred on the act of registration. However, the Commissioner argues that the rules on taxing land sales are not intended to capture a disposal that is just a mechanical transfer from an owner to themselves (in the same capacity), which cannot in any sense be considered a dealing with land (subject to the reservations relating to the application of the *Sharkey v Wernher* principle discussed in paragraphs 7 and 8 above).

10. The Commissioner's view is that there is no a disposal even in the broadest sense when a joint tenancy is changed to a tenancy in common (or vice versa) and the proportional shares or notional shares do not change.

11. In terms of the transactions considered in IS 22/03 this means that:

(a) A change to the form of co-ownership, where the proportional shares or notional shares do not change, will not be a "disposal" for the purposes of the land sale rules – for example, a change from 50/50 tenants in common to joint tenants, or vice versa, with the same two owners;

(b) If there is a transfer between co-owners where neither's interest is fully alienated but the proportional share or notional share of a co-owner is reduced, there would be a "disposal" for the purposes of the land sale rules by that person to the extent their interest is reduced, because while they have not fully alienated the whole estate or interest they had in the land, they have fully alienated part of their interest in land – for example, in the case of a change from 50/50 co-ownership to 75/25 co-ownership by the same owners, there would be a disposal relating to the change from 50% to 25%;

(c) If there is a transfer that adds a new co-owner, there would be a "disposal" for the purposes of the land sale rules to the extent the share (or notional share) of the original owner(s) in the land is reduced – for example, in the case of 50/50 co-ownership

changing to a one-third ownership by 3 owners, there would be disposals by both original co-owners;

(d) If there is a transfer that removes a co-owner, there would be a "disposal" by the departing co-owner of their share (or notional share) in the land – for example, in a change from 3 equal co-owners to 2 equal co-owners, there would be a disposal by the departing co-owner;

(e) There would not be a "disposal" of an interest in land if the owner subdivides the land and all of the new resulting titles are issued to them or, in the case of joint owners, all new titles are issued to the original owners in the same proportions or notional proportions that they held in the undivided land;

(f) However, there would be a "disposal" if the owner subdivides the land and one of the newly created titles was issued to someone else – for example, if an owner subdivides land and one of the new titles is issued directly to a purchaser, there would be a disposal by the original owner of the land comprised in the new title issued to the purchaser;

(g) There would also be a "disposal" where there is a subdivision of land by co- owners into multiple titles and the new titles are not issued to all co-owners of the undivided land together, in the same proportions or notional proportions as they held the undivided land. The most common example of this would be where each of the co-owners is issued one of the newly created titles;

(h) A transfer of land on a change of trustees of a trust will not be a disposal for the purposes of the land sale rules. The ITA treats all of the trustees of a trust as essentially a single person, and "disposal" in the land sale rules does not include transfers to self (in the same capacity).

Common subdivisions

12. Inland Revenue notes that the most common subdivisions are where:

(a) A lot of land is subdivided into multiple newly created lots, with a new title issued for each;

(b) A unit title plan is deposited and separate titles for units on the plan are issued;

(c) A cross-lease title is converted to a fee simple, which results in separate titles being issued.

Extinguishment vs disposal to self

13. Inland Revenue states that:

(a) If different forms of co-ownership are different interests in land, or in the case of subdivisions where Land Information New Zealand ("LINZ") cancels an existing title and issues new titles, there is an extinguishment of an interest in land raising the question of whether there is a disposal in such circumstances;

(b) If different forms of co-ownership are not different interests in land but different ways of owning the same land, there would be a 'disposal to self', because registration of a transfer has the effect of transferring the land specified in the instrument under the *Land Transfer Act 2017*, and a person can dispose of property to themselves (alone or

jointly with another person) under s 56 of the *Property Law Act 2007*, and the question arises as to whether a disposal for the purposes of the land tax rules includes disposal to self or whether there has to be alienation of the property to someone who previously did not own it;

(c) The question of disposal to self is also relevant when land is transferred due to a change in trustees, because different trustees are treated as the same single person for tax purposes.

Joint tenancy vs tenancy in common

14. Inland Revenue notes that in a joint tenancy, the attributes are:

(a) The right of survivorship – i.e. if a joint tenant's rights are extinguished, the rights accrue to the remaining joint tenants;

(b) The "four unities", being unity of possession (the joint tenants are equally entitled to all of the land, without any right to any particular part), unity of interest (the joint tenants hold a single estate), unity of title (all joint tenants derive their title from the same instrument) and unity of time (the estate of each joint tenant must have become vested at the same time);

(c) A prospective notional or separate share and the inalienable right to sever their share during their own lifetime – for example, if one of 2 joint tenants were to sever their share, each will have a half, and if one of 4 joint tenants severs their share, they will have a quarter share, and the other 3 will continue as joint tenants;

(d) Severing a joint tenancy brings it to an end and the parties then hold the land as tenants in common.

15. In a tenancy in common, Inland Revenue states the attributes are:

(a) The co-owners hold undivided shares in the same parcel of land, each with a present entitlement to a distinct share – i.e. they have possession of the whole, but entitlement to only a distinct share;

(b) A tenancy in common can be created expressly (indicating that co-owners are to have separate shares in the property), by implication of equity (for example, if the purchasers provided money in unequal shares), or by severance of a joint tenancy;

(c) There is no right of survivorship and only the unity of possession is essential for a tenancy in common.

Changing the form of co-ownership

16. Co-ownership can be changed legally or equitably:

(a) A legal change requires registration of the appropriate instrument; whereas

(b) An equitable transaction may simply result in the legal joint owners holding the land in trust for the beneficial owners as tenants in common.

17. Severance of a joint tenancy can be effected by:

    (a) A joint tenant transferring their interest to themselves, where only the transferring party is entered in the transfer instrument as the transferor – for example, where A and B are joint tenants and A is the transferor, after which the land will be held as ½ A. ½ B;

    (b) Both joint tenants being transferors where the register of land will show a transfer from A + B to A ½, B ½.

18. The co-owners' proportional shares can also be changed:

    (a) Within a tenancy in common from ¼ A, ¾ B, to 50:50; or

    (b) From a joint tenancy to tenants in common with unequal shares.

19. In the Commissioner's view, the form of co-ownership is not itself an interest in land. The definition of land refers to proprietary interests, and not the manner in which the interests are held. Therefore, co-owners do not have different interests in land to what they previously had when the form of co-ownership changes.

How this conclusion reconciles with the Commissioner's view in QB 17/09

20. In QB 17/09 Is there a full or a partial disposal when an asset is contributed to a partnership as a capital contribution? *Tax Information Bulletin* Vol. 30, No. 1, February 2018, the conclusion was that there would be a full disposal when land jointly owned by two persons was transferred to a 50/50 partnership of the same persons. It is noted in IS 22/03 that:

    "This is different to a situation where joint tenants sever the joint tenancy to hold the land as 50:50 tenants in common, or where a 50:50 tenancy in common is converted to a joint tenancy. Before and after the transfer to effect the change to the form of co-ownership, each party's interest in the land was owned in their personal capacity. Their proportionate or notional proportionate shares in the land are unchanged.

    In the Commissioner's view this is different from a situation where land is transfer from A & B jointly to A & B in their capacity as partners in a partnership. In that situation, there is a change in terms of ownership of the land, as it is now partnership property and owned by the partners in their capacity as such."

Bright-line test implications where proportional shares do not change

21. There are specific provisions that ensure the start date for the bright-line test does not reset on the registration of a transfer to effect a change to the form of co-ownership where the proportional or notional shares do not change: s CB 6A(5B) and (5C).

When parties' proportional shares change or a co-owner is added or removed

22. In the Commissioner's view, if there is a transfer between co-owners where neither's interest is fully alienated but the proportional or notional share of a co-owner is reduced, there is a "disposal" for the purposes of the land sale rules by that person to the extent their interest is reduced. This is because while they have not fully alienated the whole estate or interest they had in the land, they have fully alienated part of their interest in land.

23. The Commissioner maintains this is consistent with s CB 23B which deals with when land is partially disposed of or disposed of with other land.

24. As far as the bright-line test is concerned, there are specific provisions that ensure the registration of a transfer to change the proportionality of co-ownership will result in the bright-line clock restarting only to the extent a particular party's interest has increased: s. CB 6A(5D) and s CZ 39(5D). To the extent that a party already owned the land, the bright-line clock does not reset.

25. Similarly, if a transfer:

    (a) Adds a new co-owner, there would be a "disposal" for the purposes of the land sale rules to the extent the share (or notional share) of the original owner(s) in the land is reduced; and

    (b) Removes a co-owner, there would be a "disposal" by the departing co-owner of their share (or notional share) in the land.

26. Again, in relation to the application of the bright-line test, there are specific provisions that ensure that the registration of a transfer to add or remove a co-owner will result in the bright-line clock restarting (or starting) only to the extent a particular party's interest has increased: s CB 6A(5D) and s CZ 39(5D).

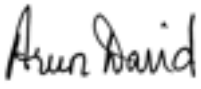
When trustees change

27. When trustees change, the legal title to the land would be transferred from the existing trustees to the new trustees.

28. As previously noted, in the Commissioner's view, "disposal" in the land sale rules does not include transfers to self (in the same capacity). As such, the Commissioner does not consider that a transfer of land on a change of trustees of a trust will be a disposal for the purposes of the land sale rules.

29. The bright-line period does not restart on the registration of a transfer instrument to effect a changes of trustees: c CB 6A(3B) and s CZ 39(6).

30. However, there will be a disposal where land is transferred from the trustees of "Trust A" to the trustees of "Trust B", where the trustees of both trusts are the same. It is not a 'disposal to self', as the trustees are acting in different capacities as trustees of Trust A and trustees of Trust B (just as they are acting in different capacities in their trustee capacities and in their personal capacities). Likewise, there would be a disposal if someone transfers land from themself in their personal capacity to themself as trustee for a trust (for example, "A" disposes of property to "A as trustee for the A Family Trust"). That would not be a 'transfer to self' because of the different capacities.



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