

The Bright Line Test

Let's talk about tax

Trust us, we know. Tax is not the most glamorous topic of conversation. Nor is it the simplest. In many cases it feels like a sensible decision to simply leave all that “tax stuff” to your accountant and continue living in blissful ignorance.

However, it is also true that some level of understanding can be empowering as you make financial decisions and stay up to date with your tax obligations. Without subjecting you to an analysis of all 3285 pages of the Income Tax Act 2007, we wanted to share some general information about a recent (and important) change to the tax laws that may affect you if you are buying or selling residential property.

Bright Lines

Before October 2015, New Zealand’s tax laws said (somewhere amongst those 3285 pages) that you could be taxed on any gains you made buying and then selling a property if you had “an intention to resell” the property when you purchased it. As it turns out, it’s relatively hard for the IRD to apply this test because they had no way of proving what peoples’ intentions were.

To deal with this, the IRD decided to introduce a new test that would work alongside the old test and they called it the “Bright-Line Test” (or in some cases, the Bright-Line Rule). This Bright-Line Test, said the IRD, would be a clear, unambiguous and obvious test that determines when a person should be taxed on gains made from buying and later selling property. It is a sort of “shortcut” as it draws a bright line to determine who needs to pay tax on property gains, removing the need for the IRD to consider personal intentions in each case.

Under the test, if you buy a residential property on or after 1 October 2015, and you sell this property within two years, you will be taxed on any gains that you made, *regardless of your intention when you bought the property*, unless you can prove that you fall within one of the four main exceptions to this rule.

Under the exceptions, you won’t be taxed on any gains you have made in relation to a property bought and sold within two years if:

- That property was your “main home”;
- You inherited the property;
- The property was transferred to you under a relationship property agreement after a relationship breakdown; or
- That property was transferred under a will (for example, to an administrator or executor).

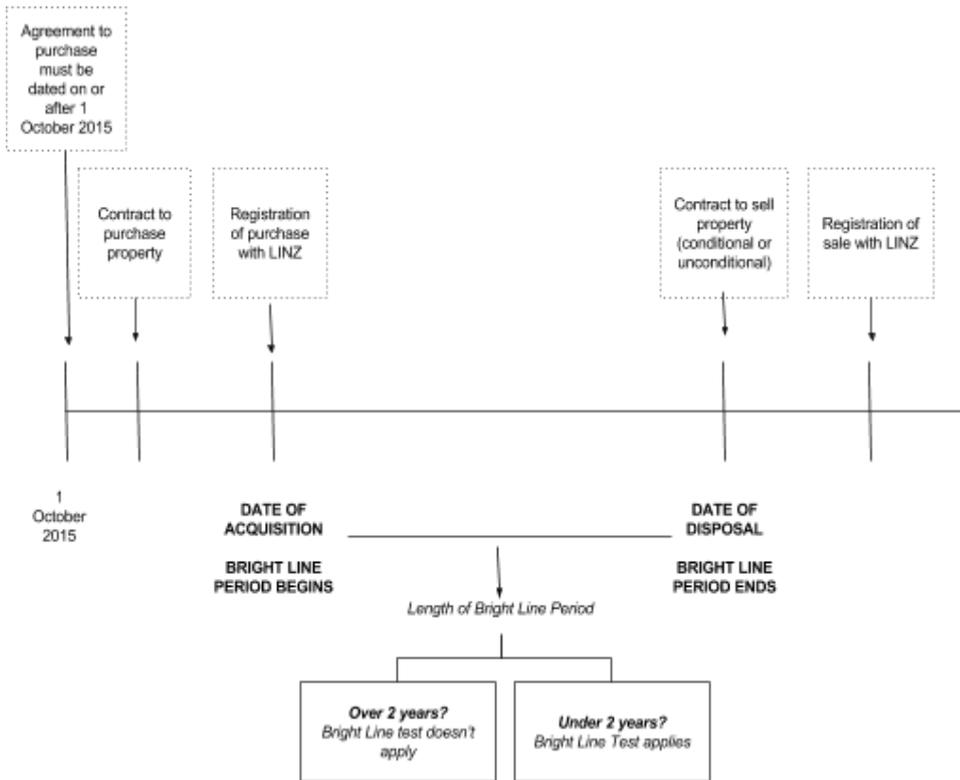
Let's break it down – The crucial Ingredients of the bright-Line test

The law loves definitions and it turns out that specific definitions really can make a difference when we're talking about the Bright-Line Test. Here are the important ones that determine, as a starting point, if the Bright-Line Test will apply to your situation:

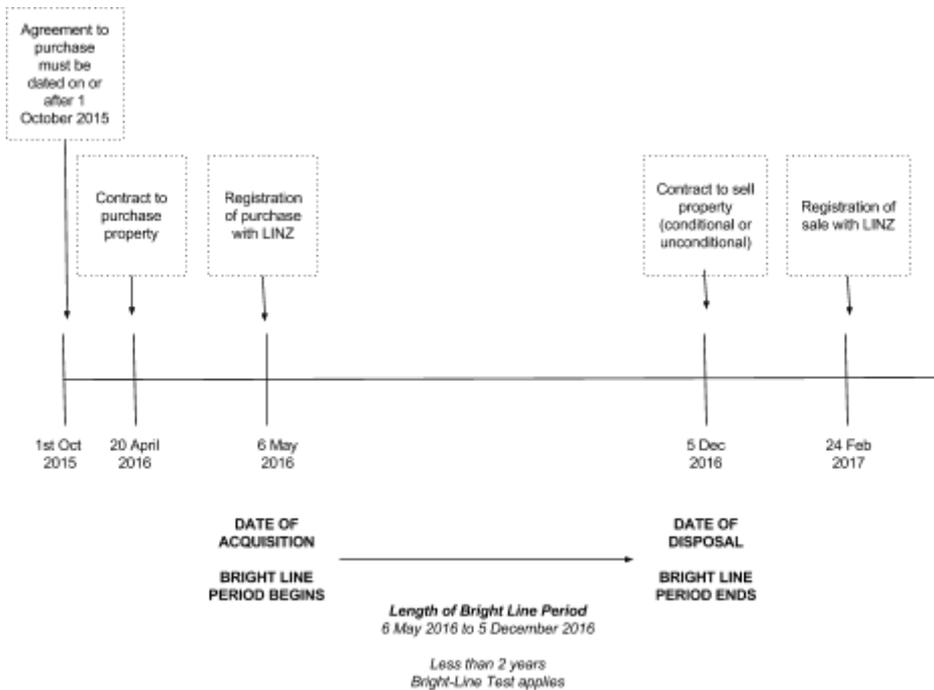
- **Residential Land:** The Bright-Line Test only applies to residential land, which technically means land that has a dwelling on it, or land for which there is an arrangement to build a dwelling on it. A dwelling is a place that is used predominately as a place of residence (and doesn't include hotels, motels, hospitals, campground, serviced apartment rest home other listed exceptions in the Income Tax Act). Residential Land also includes bare land that is capable of having a dwelling put on it. Residential land does not include land that is used mainly as business premises or as farmland.
- **Two years:** The application of the Bright-Line Test is all about timing. The law has limited the application of the test to a period of two years, asking if you bought and sold a property within two years. It therefore becomes important to know when that two-year period starts and ends:
 - **Start/Purchase Date:** The purchase date will generally refer to the date when your purchase of the land was officially registered with Land Information New Zealand (note that there is a different rule if the property is outside of New Zealand). The clock starts here in terms of the two-year period.
 - **End/Sale Date:** The sale date, however, is not the date of registration of the sale. It will usually be the date that you sign the agreement to sell the property, although there are different rules in specific (relatively unusual) circumstances.

Note that the Bright-Line Test only applies to agreements for the purchase of property that were signed *on or after* 1 October 2015. It would be unfair for people who entered into purchase agreements before the law change to be subject to the Bright-Line Test. In that case, the old tax laws relating to property will apply.

Here's a diagram to show you how to measure the two-year period in practice:



Example of the Bright-Line Period in action



How about those exceptions?

If the conditions of the Bright-Line Test are satisfied (meaning that we're talking about residential land being bought and sold within the two-year window), the next question is whether any of the exceptions to the Bright-Line Test apply. The exceptions are a crucial part of this regime and, as we said earlier, the Test won't apply in relation to a property if:

- **That property was your “main home”:** If you buy and sell your main home within two years, the Bright-Line Rule will not apply and you will not be required to pay tax on any gain you make. Your main home is a home that:
 - You've actually used as your main home for 50% of the time that you've owned it. What's a main home anyway? Basically it is the home you have the greatest connection with based on factors like: How long you spend there, your social ties to the area, your use of the house, your employment, business and economic ties and where you keep your personal property.
 - You've used mainly as your home, that is to say that 50% of the area of your property is used as your main home. For example, if you rent out two thirds of your property, it would not be your main home because it isn't used mainly as your home, it's main purpose is a rental property.
 - Is your only main home. You can't have more than one main home. If you live in more than one house, your main home is the one that you have the greatest connection to.

You can only use the main home exception twice in any two-year period. It also doesn't apply if you show a regular pattern of buying and selling residential property.

- **You inherited the property:** The Bright-Line Rule does not apply if you sell a property you inherited within two years from the date that the property was transferred to you under a Will.
- **The property was transferred to you under a relationship property agreement after a relationship break down:** If you receive a property as part of a relationship settlement agreement, you won't need to pay income tax on the property when it's transferred to you. However, if you go on to sell this property within two years of its *original* purchase date (not the date it was transferred to you), the Bright-Line Rule will apply.
- **That property was transferred under a Will to an administrator or executor of the estate:** The Bright-Line Rule does not apply if the land was transferred from a deceased owner to a new owner who is the administrator or executor of the deceased person's estate.

So, if I just wait two years, am I safe from paying tax on gains from my property sale?

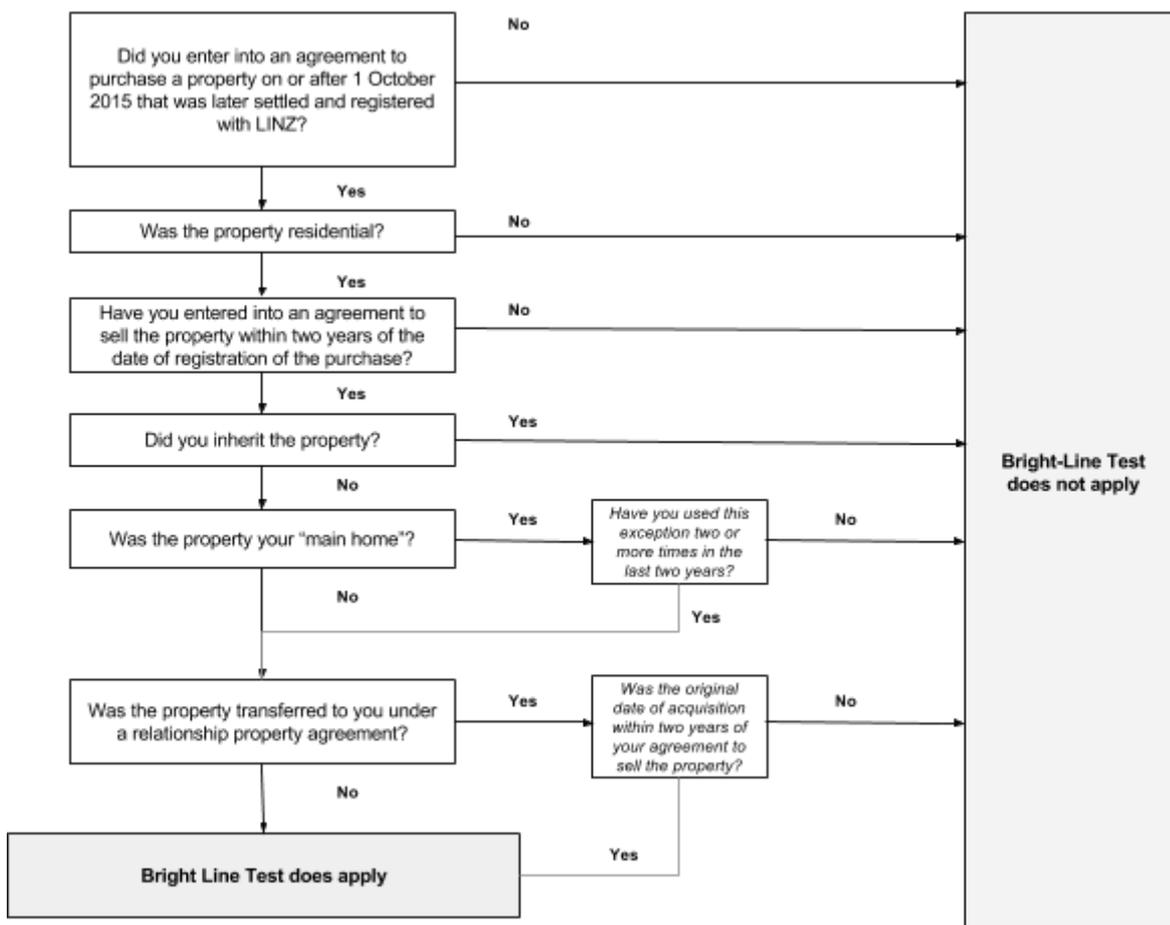
Not necessarily. If you sell a property more than two years after buying it, the Bright-Line Test won't apply to you. But the *intention test* may still apply as the Bright-Line Test doesn't replace this, it only supplements it. Therefore, if you buy a property with the intention of reselling it, it doesn't matter how long you hold onto it for, the gain on the resale will be taxable. There is an entire regime of tax laws beyond the Bright-Line Test that apply to the buying and selling of

residential properties that are worth investigating. You can ask your lawyer for specific advice that applies to your situation.

It looks like the bright-line rule applies to my situation. What happens now?

If the Bright-Line Rule applies to you, any gains on your sale will be taxed at your normal income tax rate. You will need to include the gain in your income tax return for the year. If you make a loss, this loss will “ring-fenced”, meaning that if you owe tax on another property sale in the future, you can subtract the "ring-fenced" property loss from the income you earned on this later sale. That means you'll pay less tax on the later sale. For more information on gains and losses made from selling residential property, we suggest you contact your lawyer or accountant for some personalised advice.

Overview of The Bright-Line Test



Have a question about the Bright-Line Test? Or perhaps you just fancy a chat about how this applies to your situation? If so, we would love to help. You can give us a call or send us an email for more information.

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