Tax Working Group Information Release

Release Document

February 2019

taxworkinggroup.govt.nz/key-documents

This paper has been prepared by the Secretariat to the Tax Working Group for consideration by the Tax Working Group.

The advice represents the preliminary views of the Secretariat and does not necessarily represent the views of the whole Group or the Government.

Some papers contain draft suggested text for the Final Report. This text does not constitute the considered views of the Group. Please see the Final Report for the agreed position of the Group.

Key to sections of the Official Information Act 1982 under which information has been withheld.

Certain information in this document has been withheld under one or more of the following sections of the Official Information Act, as applicable:

[1] 9(2)(a) - to protect the privacy of natural persons, including deceased people;
[2] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials;
[3] 9(2)(g)(i) - to maintain the effective conduct of public affairs through the free and frank expression of opinions;
[4] 9(2)(j) - to enable the Crown to negotiate without disadvantage or prejudice.

Where information has been withheld, a numbered reference to the applicable section of the Official Information Act has been made, as listed above. For example, a [1] appearing where information has been withheld in a release document refers to section 9(2)(a).

In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

Coversheet: **The excluded home**

Position Paper for Session 19 of the Tax Working Group
28 September 2018

Purpose of discussion

The purpose of this paper is to provide the Group with further information and analysis to assist with the Group's decisions regarding the design of an exclusion for the family home (referred to as the "excluded home") from any proposed extension to the taxation of capital income. It also proposes draft text for inclusion in the Final Report (Appendix A).

Key points for discussion

This paper:

a. Provides further comments on the interim decisions the Group has already made regarding the definition of an "excluded home". In this respect, Officials are looking to obtain more clarity on some of the aspects of the Group's definition, and how various aspects will work together.

b. Discusses options for dealing with properties that are the main residence for the owner and their family, but are also used for other purposes (for example, home offices, Airbnb, and sharing a main residence with a flat-mate).

c. Discusses options for taxing properties that move in and out of the "excluded home" definition, both temporarily, and once and for all (for example, where a person who used a property as their main home moves out of it).

Recommended actions

We recommend that you:

a. **agree** on those further issues raised by Officials regarding clarification of the definition of the "excluded home". Officials recommend that:

   - The Group consider whether the "excluded home" exclusion would apply to Māori freehold land.
   - The "centre of vital interests" test be replaced with a "permanent place of abode" test, with an election where a person has two "permanent places of abode". Noting that this is not supported by the Independent Advisor who prefers an 'ordinarily resident' test.
   - The reference to a "person and their family" be change to a reference to a "person, or a person and any member of their family living with them".

- The “excluded home” exclusion should be able to apply to two homes during the period where one house is being acquired or constructed, and another is being held for sale.

b. **agree** to a method for dealing with properties that are partially used for other purposes. Officials recommend that a “mainly” test be adopted, with some minor exceptions. Noting that this is not supported by the Independent Advisor who prefers an explicit de minimis.

c. **agree** to a method for dealing with properties that move in and out of the “excluded home” definition. Officials recommend that a straight line apportionment method be adopted in all situations where there is a change of use.

d. **agree** to Appendix A being used as the basis for draft text for the Final Report.

The excluded home

Position Paper for Session 19
of the Tax Working Group

September 2018

Prepared by Inland Revenue and the Treasury

TABLE OF CONTENTS

1. Introduction 6
   - 1.1 Purpose 6
   - 1.2 Content and scope 6

2. Problem definition and objectives 7
   - 2.1 Context 7
   - 2.2 Policy problem or opportunity 7

3. Policy considerations 9

4.0 Definition of the excluded home 10
   - 4.1 Group's decisions to date 10
   - 4.2 Rules for Māori freehold land 10
   - 4.3 More than one residence – "centre of vital interests" test 11
   - 4.4 "Person and their family" 14
   - 4.5 One excluded home – Family units 14
   - 4.6 One excluded home – Period of sale and purchase/construction 16
   - 4.7 Property is occupied "mainly" as a residence 17
   - 4.8 Periods of absence 17
   - 4.9 What do other countries do? 17

5. Partial use 21
   - 5.1 Introduction 21
   - 5.2 Options 21
   - 5.3 Examples 24
   - 5.4 Officials' recommendations 26
   - 5.5 Farmland and lifestyle blocks 26
   - 5.6 What do other countries do? 27

6.0 Changes of use 29
   - 6.1 Introduction 29
   - 6.2 Options 29
   - 6.3 Examples – Simple changes of use 31
   - 6.4 Examples - Temporary changes of use 33
   - 6.5 Officials' recommendations 34
   - 6.6 What do other countries do? 35

Appendix A: Suggested text for Final Report 38
   - The excluded home 38

References 45

1. Introduction

1.1 Purpose

1. The purpose of this paper is to provide the Group with further information and analysis to assist with the Group's decisions regarding the design of an exclusion for the family home (referred to as the "excluded home") from any proposed extension to the taxation of capital income.

2. This paper has been prepared by the Secretariat. However, the Independent Advisor has contributed text to it on an "on exceptions" basis, where she disagrees with the Secretariat view. It also contains some comments from the Independent Advisor.

1.2 Content and scope

3. This paper will focus on three main areas:
   - Further comments on the interim decisions the Group has already made regarding the definition of an "excluded home".
   - Options for dealing with properties that are the main residence for the owner and their family, but are also used for other purposes (for example, home offices, Airbnb, and sharing a main residence with a flat-mate).
   - Options for taxing properties that move in and out of the "excluded home" definition, both temporarily, and once and for all (for example, where a person who used a property as their main home moves out of it).

2. Problem definition and objectives

2.1 Context

4. The Group has been asked to consider the design of a potential extension of the taxation of capital income. However, the Group has been instructed that any proposal must exclude the family home and the land under it.

2.2 Policy problem or opportunity

5. In Appendix B to the Interim Report, the Group set out their preliminary conclusions with regard to the definition of an "excluded home". In summary, the Group's interim decision is that the "excluded home" would have the following features:

   - The property has been occupied mainly as a residence by the person and their family as their family home or "centre of vital interests".
   - The property is used as the family home up to the time of sale (however, some allowance can be made for a period of up to 12 months where the home is empty while it is held for sale).
   - At any one time, the exclusion would only apply to one property owned by a person.
   - The exclusion would only apply to people who are tax resident in New Zealand (taking into account the application of double tax agreements).
   - The exclusion would apply to a property owned by a trust if the person living in the property is the settlor of the trust, or a beneficiary who is irrevocably entitled to the property.
   - The exclusion would apply to shares in a flat owning company, provided the person or persons who own the shares occupies the property as their family home.
   - The exclusion would apply to a property owned by an ordinary company or look through company, provided the person or persons who own the shares occupies the property as their family home.
   - The exclusion would still apply where the person temporarily lives in another place for up to four years.
   - The exclusion would apply to land of an area up to the greater of 4,500m^2, or the amount required for the reasonable occupation and enjoyment of the house.
   - Consideration also needs to be given as to whether there should be a cap of $5 million in value.

6. This paper builds on the work the Group has already done in defining the "excluded home" in Appendix B to the Interim Report. This paper further discusses how the

"excluded home" should be defined, and options for dealing with situations where the property is concurrently used for other purposes (referred to in this paper as partial use), or where there is a complete change of use of the property.

7. We note that the partial use and change of use principles discussed in this paper will also apply to other types of property where the use changes from private to income earning or vice versa.

3. Policy considerations

8. In determining which option is to be preferred, it is helpful to take into account various policy considerations. These considerations can then be weighed and decisions can be made about which are more important in this context.

9. Officials have identified the following factors that appear to be relevant for the design of the "excluded home" exclusion:

   - **Terms of reference** – The Group has been instructed that an extension of the taxation of capital income should not include the family home and the land under it.
   - **Simplicity** – Simple rules are easier for taxpayers to understand and apply. However, simplicity can lead to a lack of accuracy.
   - **Accuracy** – Rules that require detailed calculations of actual use of a property give rise to a more accurate tax outcome. However, such rules are often complex and time consuming for taxpayers to apply.
   - **Certainty** – Rules that involve objective tests that are obvious to apply and provide more certainty for taxpayers than subjective tests that can lead to different views as to the outcome. Where there can be differing views, this can lead to disputes between taxpayers and Inland Revenue.
   - **Ability to pay** – The ability of a taxpayer to pay a tax liability should be taken into account when determining when that liability should arise.
   - **Level of compliance costs** – The level of costs that taxpayers will be required to incur in order to comply with the rules is also a relevant consideration.

10. It is also helpful to take account of the rules that apply in other countries when determining appropriate rules for New Zealand, because they have dealt with the same issues before. On this basis, this paper includes brief summaries of the rules that apply in some other countries for comparison purposes.

11. Ultimately, Officials consider that the appropriate policy setting for the design of an "excluded home" exclusion is to design rules that are simple to apply for average taxpayers, which will keep compliance costs low, and which will provide certainty. In particular, Officials would prefer to err on the side of a more liberal definition of the "excluded home" and exclude too much, than on a less liberal definition that may exclude too little. It is also important to bear in mind that in the vast majority of cases, the "excluded home" will be easy to identify, and this paper therefore focuses on more marginal situations.

4.0 Definition of the excluded home

4.1 Group's decisions to date

13. As discussed above, the Group has made a number of interim decisions regarding the features of the "excluded home" exclusion in Appendix B to the Interim Report.

14. This paper discusses some of those features in more detail, in order to test how they will work in practise, and outlines some other options or issues that Officials have identified. Officials also raise the issue of how the rules should apply to Māori freehold land.

4.2 Rules for Māori freehold land

15. Officials recommend that the Group give some consideration as to whether the "excluded home" exclusion should also apply to Māori freehold land.

16. As stated above, the terms of reference require that the family home and the land underneath it not be subject to any extension on the taxation of capital income. Officials note that there is no explanation for this exclusion. However, the Independent Advisor in her paper *Maori assets and capital income* noted that, while a gain on a family home (whether realised or not) does increase a person's wealth, generally speaking it does not increase the person's consumption potential as it simply represents a place to live and connect with their family. That is it is their turangawaewae.

17. The family home in the Pākehā sense of the term is the house that is the centre of family connections for the individuals who live there. While the nuclear family (i.e., parents and young dependent children) is the most common representation of family in New Zealand, even for Pākehā family is increasingly taking on broader connotations involving blended families (for example, grandparents raising grandchildren, and significant delay for adult children leaving to set up their own households).

18. For Māori the concept of home is even broader. This was discussed in a recent report on Māori housing:[1]

> The Productivity Commission and other researchers over this time have found that home for Māori starts with the ancestral home-place: important to Māori cultural identity. Home-place links are reinforced by physical associations with land, whakapapa, proximity to extended family, experience of te reo, and the importance of the marae. Home is about whānau, **whenua** and whakapapa. [Emphasis added]

[1] http://www.buildingbetter.nz/publications/SRA5/Maori_and_indigenous_housing_annotated_biblography.pdf

19. On this basis, Officials note that it is worth considering whether Māori freehold land is sufficiently analogous to the concept of a family home for it also to be exempted under the concept of "excluded home".

20. Officials note that the comparison between Māori freehold land and the family home concept is not strictly "like for like". For example, the argument that Māori freehold land **is** a family home would be more difficult to support for those connected to the land but not living there on a day-to-day basis. There appears to be a stronger argument that there is an analogy between the two concepts that might justify a similar exclusion. On this basis, Officials will continue considering the inter-relationship between Māori freehold land and the excluded home concept. Our views on this subject will be provided, following consultation, as part of the future Secretariat paper on the Māori asset base.

4.3 More than one residence – "centre of vital interests" test

21. Where a person owns two or more properties that they use as residences, the Group has suggested the use of a "centre of vital interests" test for determining which residence will be their "excluded home".

22. The "centre of vital interests" test is the test imposed under many double tax agreements (DTAs) internationally, to determine the tax residency of a person, for DTA purposes, where they are residents in two different countries under domestic law. It requires consideration of where a person's personal and economic relations are closer. The OECD commentary on article 4 of the OECD Model Convention (which determines a person's tax residency for DTA purposes) indicates that the following types of factors may be taken into account in applying the "centre of vital interests" test (at [15]):

> … regard will be had to his family and social relations, his occupations, his political, cultural or other activities, his place of business, the place from which he administers his property, etc. The circumstances must be examined as a whole, but it is nevertheless obvious that considerations based on the personal acts of the individual must receive special attention. If a person who has a home in one State sets up a second in the other State while retaining the first, the fact that he retains the first in the environment where he has always lived, where he has worked, and where he has his family and possessions, can, together with other elements, go to demonstrate that he has retained his centre of vital interests in the first State.

23. As can be seen from the commentary, the "centre of vital interests" test measures a person's ties to a general locality, rather than to a particular home. It refers to the fact that someone can retain their "centre of vital interests" in one place, despite living in another. It also refers to broader personal connections to an area, such as extended family ties, political and social ties, and cultural and other activities. On that basis, Officials suggest that this may not be the best test to use to determine which home should be a person's "excluded home".

Alternative option – Permanent place of abode

24. An alternative to applying the "centre of vital interests" test is to apply a test similar to the New Zealand "permanent place of abode" test. This test is contained in s YD

1 of the Income Tax Act 2007, and is used to determine whether a person is resident in New Zealand for domestic tax law purposes.

25. The "permanent place of abode" test measures a person's connection with a particular home. The term "permanent place of abode" is not defined in the Income Tax Act 2007. It has been described by the Court of Appeal as meaning a place where a person habitually resides from time to time even if they spend periods of time overseas.[2] This test has been considered on multiple occasions by the New Zealand courts, and various factors have been formulated for determining whether a person has a "permanent place of abode". Relevant to the "excluded home" exclusion, the courts have suggested that it is necessary to consider the durability of the person's association with the place of abode and how close their connection with it is.

26. The cases establish that some of the material factors to be considered when assessing whether a person has a durable association with a place of abode, such that it can be regarded as their permanent place of abode, are:

- the nature and use of the dwelling and the person's connection with the dwelling;
- the person's intentions;
- the person's family and social ties;
- the person's employment, business interests and economic ties;
- the person's personal property; and
- any other factors that shed light on whether the place of abode is a permanent place of abode for the person.

27. These factors are relevant to the extent they indicate whether the person habitually resides in a particular dwelling. The same factors are considered to determine which house is a person's main home, for the purposes of the bright-line main home exclusion, if they have more than one home.

28. A benefit of using a test based on the "permanent place of abode" test for determining whether a house is a person's "excluded home", is that this test is already used in New Zealand tax law, and has already been considered by the courts. The Commissioner has also produced a comprehensive statement discussing how this test works (IS 16/03 "Tax Residence").

29. The only problem with applying a "permanent place of abode" test is that it is not designed to identify a single property. Instead, it could identify that a person has more than one "permanent place of abode" in New Zealand (the tax residence rules in the Income Tax Act 2007 acknowledge that someone may have more than one permanent place of abode; they focus on whether the person has one in New Zealand).

---

[2] *CIR v Diamond* [2015] NZCA 613.

30. The Independent Advisor does not support the use of the term *permanent place of abode* as part of the determination of excluded home. This is because the current concept of *permanent place of abode* focuses on whether or not an individual is tax resident in New Zealand and therefore liable to tax on foreign income in New Zealand.

31. Consequently the case law considers situations where individuals are not residing in New Zealand. This is shown by the most recent case which interprets *permanent place of abode* as when an individual: ***habitually resides from time to time even if they spend periods of time overseas.***

32. In the Independent Advisor's view, for an excluded home definition, as in comparable countries the focus should simply be on the place an individual 'habitually' or ordinarily resides when living in New Zealand. She acknowledges that the approaches taken by other countries also have definitional issues but New Zealand could rely on their case law which is directly relevant to the policy concern.

33. Officials recommend consideration of two alternative approaches:

    - A permanent place of abode test, altered to identify one main property.
    - A permanent place of abode test, with an election option where a person has two permanent places of abode.

34. The first alternative is to alter the "permanent place of abode" test in this context to identify one property. Thought would have to be given to how this would be done. However, it is likely that this would involve a further balancing of factors.

35. Officials note, however, that the use of any test that requires various subjective factors to be weighed will result in uncertainty for some taxpayers, and is likely to lead to disputes.

36. An alternative is to allow a person who owns two properties that satisfy the "permanent place of abode" test to elect which one is their "excluded home". A person would still only be able to have one "excluded home" at any one point in time.

37. There appear to be two options for the timing of an election:

    - An election could be made at the time of sale of the first residence, as part of the tax statement that is already required to be completed as part of every land sale, reporting the years of ownership when the person has elected that the property was to be their "excluded home".
    - Alternatively, an election could be required when a person acquires a property, again as part of the tax statement that is already required to be completed as part of every land sale, with further elections each time the property changes use.

38. The benefit of an election approach is that it provides certainty for taxpayers. If the elections can be made through the tax statements that are already required as part

of every land sale, this will also require relatively little compliance, compared with the need to obtain complex tax advice where the application of the exclusion is based on subjective factors.

39. However, there is a risk with this option that a person will always choose their more expensive home at any time.

Examples

40. The following example illustrates how these options would apply:

> ***Example – Multiple homes***
>
> Jamie and Cam are married and own a small home in Auckland. Both of them often travel to Hamilton for work so decide to buy a second home in Hamilton. At first, they split their time relatively evenly between the two homes. As Jamie's business expands, she finds herself spending more time in Hamilton than in Auckland, though Cam still splits his time evenly between the two.
>
> If taxpayers are allowed to elect an excluded home, Jamie and Cam may elect their Auckland home for their entire period of ownership simply because it has increased in value more over that time, even if they spend more time in Hamilton in later years.
>
> If the permanent place of abode test is used, there is uncertainty over which home should be their "excluded home" in each year. There will also be substantial audit difficulties.

Officials' recommendation

41. Officials recommend the adoption of an election option for situations where a person has two residences. Such an option is simple, and relatively easy to apply, and provides certainty for taxpayers, which means it is less likely to lead to disputes between taxpayers and Inland Revenue. Such a rule also appears to be consistent with the rules applied in other countries. Officials recommend that the election is made retrospectively at the time that the property is sold, as this involves the least compliance for taxpayers.

4.4 "Person and their family"

42. The Group has suggested that an "excluded home" should be a property occupied mainly as a residence by the "person and their family". Officials note that a person could be living alone, without any other family members, in a property, which would still be their main home. Therefore, Officials recommend that this be re-worded to refer to the residence of "a person, or a person and any member of their family living with them". This is the wording used in other residential exclusions from the land sale rules (for example, s CB 16).

4.5 One excluded home – Family units

43. The Group has suggested that a person and their family (a "family unit") can only have one "excluded home" at any time. However, the Group has also suggested that, where two people who are married, or in a civil union or a de facto relationship, are genuinely living apart, they can each have an "excluded home".

44. In order to clarify how these two principles will work together, Officials recommend that further consideration be given to how a "family unit" is defined, in order to determine when people that may be considered part of the same "family unit" could live apart.

45. Officials recommend that a "family unit" be defined as a person and the following persons (if any):

- their spouse, civil union, partner or de facto partner, unless:
  - they are legally separated; or
  - they usually live in separate homes, that are owned individually by each of them; and
- their children under the age of 18 years; and
- any other member of their extended family who is living with them.

46. Officials recommend that a "family unit" can only have one "excluded home" at any one time. If a "family unit" has more than one residence that could be an "excluded home" at any one time, an election must be made to determine which of those residences will be the "family unit's" "excluded home".

47. These recommended rules are consistent with the rules that apply in other countries.

Examples

48. The following examples illustrate how the above rules recommended by Officials would operate.

> ***Example 1 – One "family unit"***
>
> Karen and her husband own a house in Wellington where they live with their two small children (ages 4 and 7). Karen and her husband also own an apartment in Auckland where Karen stays two to three days a week when she is working in Auckland. The family also spend approximately six weeks per year (during school holidays) living in the Auckland apartment as a family.
>
> Karen, her husband and their children are one "family unit". Therefore, they are only entitled to have one "excluded home". They will need to elect which property will be their "excluded home".

> ***Example 2 – Couple has separated***
>
> John and Trudy have been married for 10 years. During that time they lived together in a home they jointly own. Their relationship breaks down and they decide to separate. John remains in the home they shared, and Trudy purchases a new home.
>
> After their separation, John and Trudy can each have a separate "excluded home".

> ***Example 3 – Separate homes***
>
> Natalie and Sarah are married. However, they each own separate homes, and do not usually live together. Their personal property is kept separately in their respective separate homes.
>
> Natalie and Sarah can each have a separate "excluded home".

Example 4 – Extended family

Helen and Murray are married. They own a home that they occupy as their residence. Helen's mother, Joan, also owns a home that she has occupied for many years. However, due to Joan's ill health, it is decided that Joan will move in with Helen and Murray, and that Joan's house will be rented out.

After Joan moves in with Helen and Murray, the "family unit" will only be entitled to one "excluded home". Joan will not be able to claim the "excluded home" exclusion on her home for the period that she is living with Helen and Murray.

4.6 One excluded home – Period of sale and purchase/construction

49. As discussed, the Group has recommended that a person can only have one excluded home. However, the Group has suggested that some allowance would be made for a period of up to 12 months where the home is empty while it is held for sale (i.e., a person would be allowed two "excluded homes" during this period).

50. Officials agree with this proposal. It aligns with the principle that the rules for the "excluded home" exclusion should be simple and clear. However, Officials recommend that more consideration is given to the period of overlap that would be appropriate. Officials also recommend that this rule be limited to situations where the property is left vacant while it is being held for sale (i.e., it would not apply if a person rented the property out while it was being held for sale).

51. Officials also recommend that similar rules be considered for times when a person owns one property that is their "excluded home", and has purchased another property that consists of vacant land where they are building a new home. This would also be consistent with a more liberal definition of the "excluded home". However, once again, Officials recommend that more consideration be given to the period of overlap that will be allowed. In particular, Officials would want to limit the period so as to not allow land banking to occur.

Examples

52. The following examples illustrate how the above rules would operate.

Example 1 – Sale and purchase

Kate and Will own a property that they have occupied as their "excluded home". They decide to move to another area. They find a new home, purchase it, and move into it. However, it takes three months to sell their old home. While it is on the market, the old home is left vacant.

Kate and Will will be entitled to claim the "excluded home" exclusion for both homes for the three months that they own both.

Example 2 – Building a new home

Burt and Ernie have a home in central Wellington. They decide to purchase a vacant section in the outer suburbs and build a new home for themselves. It takes two years from the date of purchase of the vacant section for the new home to be built. During that time Burt and

Ernie continue to live in their central Wellington home. Once the new home is completed, Burt and Ernie sell their central Wellington home and move into their new home.

Burt and Ernie will be entitled to claim the "excluded home" exclusion for both properties for the two years that they owed them both.

Example 3 – Land banking

Jason and Kim have a family home that they have occupied for a number of years. They decide to purchase some vacant land, with the intention of building a new home for themselves. They hold the land for three years before they start to develop plans. Once they start to develop plans, it takes a further three years to complete the home. Once the new home is completed, Jason and Kim sell their old home and move into their new one.

Officials consider that six years is too long for the "excluded home" exclusion to apply to both properties. Such a rule may encourage people to hold vacant land. Therefore, Officials do not recommend that both properties can qualify for the "excluded home" exclusion for the whole six-year period.

4.7 Property is occupied "mainly" as a residence

53. The Group has suggested that the excluded home should be a property that has been occupied "mainly" as a residence by the person and their family.

54. Officials have considered the application of this test as an option for dealing with partial income earning use of a residential property at chapter 5 below. Officials recommend that the Group further consider whether the "mainly" test is the best test in the context of that discussion.

4.8 Periods of absence

55. The Group has suggested that a property must be used as a residence up to the time of sale, but has suggested some flexibility for temporary absence (up to 4 years).

56. Officials recommend that this issue be considered further in the context of the change of use rules discussed further in this paper.

4.9 What do other countries do?

57. For comparison purposes, Officials set out below a summary of how some other countries define their version of an "excluded home".

Australia

58. In Australia, there is an exemption for a person's "main residence". This term is not defined in the relevant legislation. Whether a property is a "main residence" is a question of fact. The following factors may be relevant in determining whether a property is a person's "main residence":

- the length of time the person lived there;
- whether the person's family lives there;

- whether the person's personal belongings are kept there;
- the address to which the person's mail is delivered;
- the person's address on the electoral roll;
- whether the property has services such as telephone, gas and power connected;
- the person's intentions in occupying the property.

59. A person is usually only allowed one "main residence". However, if a person acquires a new home before selling their old one, they can treat both homes as their "main residence" for up to six months, provided certain conditions are met. If a person has two properties that are simultaneously used as residences, a choice as to which property the "main residence" exemption will apply to is made at the time the first property is sold.

60. If a person lives in a different home to their spouse or children they need to either choose one home to be their "main residence" for both of them, or nominate the two different homes as the "main residence" for each of them. If a couple nominates different homes for the same period, each person receives an exemption for their share of the property up to 50%, so the exemption is effectively split (for example, if a spouse owns 50% of the nominated property their share is fully exempt, but if the spouse owns 100% of the nominated property, their share is only exempt for half the period).

61. If a person builds or renovates a house on land they own they can treat the land as their "main residence" for up to four years before they move in, provided they move in as soon as practicable and stay in that main residence for at least three months. The Commissioner has a discretion to extend the four year period in special circumstances.

Canada

62. Canada has an exemption for a "principal residence". A "principal residence" is defined as a housing unit (which includes a house, apartment, mobile home, houseboat), a leasehold interest in a housing unit, or a share in the capital stock of a housing corporation (equivalent to a share in a flat-owning company). The exemption will only apply where the person owns the property (including beneficial ownership), alone or jointly. The housing unit must also be ordinarily inhabited by the person or their spouse, common-law partner, former spouse or common-law partner, or child.

63. The "principal residence" exemption can apply for an income year even if the person and/or their family only inhabited the property for a short period of time in that year, unless the main reason the person owns the property is to produce income. When the property is sold, the person must designate the years that the property was the person's "principal residence" in their tax return.

64. A person can only have one principal residence per "family unit" for any one time, and can only claim the "principal residence" exemption for years when they were resident in Canada. A "family unit" is defined as the person and the following persons (if any):

- the person's spouse or common-law partner throughout the year, unless the spouse or common-law partner was separated from the person for the entire year under a court order or written agreement;
- the person's children (except those who were married, in a common-law partnership or 18 years of age or older during the year); and
- where the person was not married, in a common-law partnership or 18 years of age or older during the year:
  - the person's mother and father; and
  - the person's brothers and sisters (except those who were married, in a common-law partnership or 18 years of age or older during the year).

65. When one residence is sold and another is acquired in the same year, a person is effectively allowed to claim the "principal residence" exemption in respect of both properties (as a result of the way the gain is calculated).

66. The "principal residence" exemption does not apply for income years where a person has vacant land on which they are constructing a residence.

South Africa

67. In South Africa, there is an exemption for the first R2 million (approximately NZ$200,000) on the sale of a "primary residence". A "primary residence" is defined as a residence in which a natural person or special trust holds an interest, and which that person, or a beneficiary of the trust, or a spouse of that person or beneficiary, ordinarily resides in as their main residence, and uses or has used mainly for domestic purposes. The word "mainly" refers to a use of more than 50% measured based on floor area or time. If the property is not "mainly" used for domestic purposes it will not qualify in whole or in part.

68. The "primary residence" exclusion can only be claimed on one residence at time (though an overlapping period of up to two years may be allowed where a person is changing residences).

United Kingdom

69. In the United Kingdom, gains arising from the disposal of a "principal private residence" may be exempt. A person's "principal private residence" is a dwelling house (including a house, flat, houseboat or fixed caravan) that has been their main or only residence throughout the period of ownership.

70. The exemption will not apply if a person acquires a property with the intention of realising a gain on disposal.

71. A person can only have one "principal private residence" at a time, and if they have more than one residence, they can nominate which residence is to be treated as their "principal private residence". If no election is made, the decision will be made based on the relevant facts.

72. A person who is married or in a civil partnership, and not separated, can only have one "principal private residence" per couple. The couple can nominate jointly which residence is to be their "principal private residence" if they have more than one when they marry or are registered as civil union partners. If a couple separates, each partner can have a different "principal private residence".

5. Partial use

5.1 Introduction

73. Partial use of a property refers to a situation where a property is used for both private and income earning purposes during the time it is owed by a person. Partial use can take the following forms:

    - **Partial use on a floor area basis** – where part of a person's home (on a floor area basis) is set aside permanently for income earning purposes (for example, where a property has a dairy downstairs and a living area upstairs).
    - **Partial use on a time basis** – where a person uses their home for private purposes part of the time they own it, and for income earning purposes for the rest of time they own it (for example, where a person owns a property for 10 years, lives in it for 6 years, and rents it out for the remaining 4 years).
    - **Partial use on both a floor area and time basis** – where part of a person's home (on a floor area basis) is used for income earning purposes part of the time (for example, renting a room out occasionally through Airbnb).

74. This chapter of this paper deals with scenarios where there is partial use on a floor area basis, and partial use on both a floor area and time basis. The scenario where there is partial use on a time basis is referred to in this paper as a "change of use", and is discussed in chapter 6 below.

75. In Appendix B to the Interim Report, the Group said that, where a person partially uses their home for other purposes the exclusion should be reduced accordingly. It raised two options for doing this, being:

    - apportionment based on floor area; and/or
    - a *de minimis* rule where the home is "mainly used" as a residence by the taxpayer.

76. A *de minimis* rule would allow minor income earning use to be ignored when determining whether the "excluded home" exclusion should apply.

77. Officials have considered options for dealing with this situation, taking into account methods used in other jurisdictions, as well as the rules that are currently applied in New Zealand where properties are used for mixed purposes. This part of the paper outlines the options that Officials have identified. It also provides examples of how this would work in practice, for the Group to consider.

5.2 Options

78. Officials have identified two potential options for dealing with partial income earning use of an "excluded home", as follows:

- The first option is to allow partial income earning use, provided that the property is "mainly" used as a residence.
- The second option is to require apportionment of the net sale proceeds taking into account actual use of the property.

79. These options are discussed below.

"Mainly" used

80. The first option is to allow some income earning use of part of a residence, without any effect on the application of the "excluded home" exclusion, provided that the property is "mainly" used for residential purposes.

Example
Winston owns a five bedroom house that he uses as a residence for himself and his family. He also runs a consulting business out of one room in his house. As the area of the house used for income earning purposes is minor, and the house is "mainly" used as a residence, the "excluded home" exclusion will apply to the whole of the net sale proceeds when the property is sold.

81. This is in line with the Group's current interim decision that an "excluded home" should be a property that has been occupied "mainly as a residence by the person and their family".

82. However, the use of such a test does raise some potential issues. In particular, Officials note that the word "mainly" could have multiple interpretations, as follows:

    - The word "mainly" is used in the main home exclusion now contained in s CB 16 of the Income Tax Act 2007. The predecessor to this provision in earlier Acts used the term "primarily or principally". This term was replaced with "mainly" when the Act was re-written without any intended change in the interpretation. Case law suggests that "primarily or principally" (now "mainly") in this context refers to a use that is more than incidental.[3]
    - The term "mainly" has been interpreted in other contexts as often meaning "more than 50%".[4] However, in some contexts it indicates a higher or lower threshold. The cases are consistent in considering that word cannot be read in isolation and takes its meaning from the context in which it is used.

83. Officials recommend that "mainly" in this context be interpreted as being "more than 50%". Such an interpretation is consistent with the ordinary usage of the word "mainly". This could be stated in the legislation for clarity. The Independent Advisor notes that even 'more than 50%' could involve significant use other than as a family home. However if that were the intention of the Group her view is that

[3] *Trustees of the B Family Trust v CIR* [2013] NZTRA 05.

[4] For example, *Fawcett Properties Ltd v Buckingham County Council* [1960] 3 All ER 503 (HL).

this should be specifically provided for in the legislation rather than relying on interpretation of 'mainly'.

84. The use of a "mainly" test respects the terms of reference, because it ensures that the whole of the family home, and the land under it, will be excluded from an extension of the taxation of capital income. The use of a "mainly" test is also generally simple to apply, and will keep compliance costs low because taxpayers will not be required to carry out complex calculations when they sell their properties.

85. The Independent Advisor notes, however, that without a specific definition taxpayers will be required to justify their level of non-family home use as being consistent with a 'mainly' test.

86. However, on the margins, where there could be some debate as to whether a property is "mainly" used as a residence, such a test may not be particularly certain, and may in fact require some compliance in determining whether or not the use is above or below the 50% threshold. In addition, a "mainly" test will lead to inaccuracy, because it will allow people to use their properties for income producing purposes without having to pay any tax on any associated gains on sale.

Apportionment

87. The second option is an apportionment approach. Under an apportionment approach, the net proceeds from the sale of a property (i.e., the sale price less the purchase price and the cost of any capital improvements) are apportioned between the private and income earning uses of the property.

> ***Example***
>
> Philippa owns a house, which she use as her main residence. She uses one room of that house (making up one fifth of the total floor space) as an office from which she runs her business. When she sells the house, 4/5 of the net sale proceeds relate to the private use of the property, and can benefit from the "excluded home" exclusion. The other one fifth of the net sale proceeds relates to the income earning use, and would be subject to tax.

88. This method is currently used to determine the extent to which a person is allowed a deduction for expenditure when properties are used for mixed purposes.

89. The advantage of an apportionment approach is that it ensures accuracy. It also gives rise to some certainty, particularly on the margins, because a person will always have to carry out a calculation, rather than being left wondering whether they fall within a more subjective "mainly" threshold.

90. However, it will also give rise to higher compliance costs, because people would have to carry out potentially complex calculations when they sell their properties. Such an approach is also not simple.

91. In order to limit the compliance cost impact, a *de minimis* threshold could be considered, below which, any income earning use will be ignored (for example, where there is less than 25% concurrent income earning use, that will be ignored,

and the whole property will be treated as an "excluded home"). Such rule would effectively be a hybrid between the "mainly" test, and an apportionment approach. However, a *de mininis* threshold will still require a calculation to be carried out to ensure that the use is below the required threshold.

5.3 Examples

92. The following examples illustrate how the two options above would apply in practice.

> ***Example 1 – Areas permanently set aside for income earning purposes***
>
> George owns a two storey property. The front two rooms of the ground floor are set up as a doctor's surgery. The remainder of the house, including three more bedrooms, bathrooms, kitchen and living areas (approximately 65% of the floor area of the property), are used as George's family home.
>
> *"Mainly" approach*
>
> Applying a "mainly" approach, as 65% of the property is used as the family home of the doctor, the property is "mainly" (ie, more than 50%) used as a residence, and the "excluded home" exclusion will apply.
>
> *Apportionment*
>
> Applying an apportionment approach, the "excluded home" exclusion will apply to 65% of the net sale proceeds, but 35% of the net sale proceeds will be subject to tax.
>
> As 35% of the sale proceeds would be taxable, a proposed 25% *de minimis* suggested above would not apply to stop this portion being taxed.

> ***Example 2 – Areas used for both private and income earning purposes at different times***
>
> Mary purchases a house, which she occupies as her main home. The house has two living areas, one of which has a small kitchenette. Mary decides to advertise the use of one of the bedrooms and the second living area with the small kitchenette (approximately 33% of the total floor area of her house) on Airbnb. Mary has paying guests staying in her house for an average of 50 days each year. Mary uses those areas for her own private use at other times of the year.
>
> *"Mainly" approach*
>
> Applying a "mainly" approach to this example, the "excluded home" exclusion would apply. Both the area used (33% of the floor area) and time the area was used for income earning purposes (an average of 50 days a year) amount to minor income earning use of the property. Therefore, the property is "mainly" used as a residence.
>
> *Apportionment*
>
> Applying an apportionment approach, when Mary sells her house, she will have to apportion the net sale proceeds based on both the floor area used to derive income from Airbnb (ie, 33% of the total floor space), and based on the number of days she had paying guests (50 days each year). This will result in approximately 5% of the net sale proceeds being subject to tax (33% x 50/365).
>
> For example, if the property was sold for a $100,000 gain, the calculation would be as follows:
>
> (100,000 x 33%) x 50/365 = $4,521
>
> However, if a 25% *de minimis* is adopted, this income earning use would be ignored and the whole property would be subject to "excluded home" exclusion.

Example 3 – Areas use for both private and income earning purposes simultaneously

Thomas owns a four bedroom house. In order to pay his mortgage, he rents two of the bedrooms (approximately 25% of the floor area of the house). He also shares the use of the living areas (33% of the floor area of the house) with his flatmates.

In this scenario, the living areas are being used simultaneously for both private purposes (ie, this is part of Thomas's residence) and for income earning purposes (as part of the area that is being rented out).

"Mainly" approach

Under a "mainly" approach, the property is "mainly" being used by Thomas as his residence. He has exclusive access to two of the four bedrooms and shared access to the living areas.

Apportionment

Under an apportionment approach Thomas will be required to apportion the net sale proceeds based on the floor area devoted entirely to income earning use (ie, 25% of the total floor space).

Thomas will also be required to make an apportionment to account for the partial income earning use of the living areas. This would be based on 50% of the gain attributed to that 33% of the house. The Commissioner has previously stated the view that expenditure relating to common areas can be apportioned as 50% private and 50% deductible.[5] Officials consider that a similar principle could be applied to apportioning net sale proceeds under a new tax on capital income.

This would result in approximately 41% of the gain on sale being taxable (25% + (33% x 50%)).

For example, if the property was sold for a $100,000 gain the calculation would be as follows:

(100,000 x 25%) + ($100,000 x 33%) x 50% = $41,500

As over 41% of the sale proceeds would be taxable, a proposed 25% *de minimis* suggested above would not apply to stop this portion being taxed.

Example 4 – Part of a larger building used for income earning purposes

Ruby owns a five bedroom property which she uses to run a bed and breakfast business. Ruby uses four of the bedrooms and most of the living areas for the bed and breakfast business. However, Ruby occupies one of the bedrooms and a small living area and bathroom attached to that bedroom as her residence (approximately 20% of the floor area of the property).

"Mainly" approach

In this example, the property is not "mainly" occupied by Ruby as her residence. She only occupies 20% of the property as her residence, and the other 80% is used for business purposes. Therefore, Ruby would not be able to claim the "excluded home" exclusion in respect of this property.

Apportionment

However, if an apportionment approach is used, Ruby would be entitled to claim the "excluded home" exclusion for the 20% of the property that she occupied as a residence, and would only have to pay tax on 80% of the net sale proceeds.

[5] See "Homestays – GST treatment" in Tax Information Bulletin Vol 7, No 13 (May 1996).

5.4 Officials' recommendations

93. Officials recommend that the "mainly" approach be adopted. Officials consider that this approach better captures the spirit of the terms of reference in that it ensures that an extension of the taxation of capital income will not apply to the family home and the land under it. This approach is also relatively simple to apply, which will reduce compliance costs for taxpayers.

94. The Independent Advisor's preference, however, is for an explicit *de minimis* which could be as high as 50% as an alternative to the more uncertain use of the term 'mainly'.

95. However, Officials recommend that a limited apportionment approach could be considered for scenarios where a part of a property is set aside exclusively and permanently for income earning purposes and cannot be used for private purposes (eg, a downstairs dairy). This ensures that where part of a property is actually a business premises, that part is subject to tax. Similarly, consideration could be given to whether apportionment could apply to allow the "excluded home" exclusion to apply to a residential part of a larger building used mainly for business purposes (eg, the BnB example above).

5.5 Farmland and lifestyle blocks

96. In the context of considering partial use of a property, Officials note that rules should also be considered for farmland and lifestyle blocks.

97. The Group has suggested that the "excluded home" exclusion would only apply to the house and land around it up to 4,500m^2, or the amount required for the reasonable occupation and enjoyment of the house. On this basis, people who own farmland or lifestyle blocks (assuming most lifestyle blocks are more than 4,500m^2 would not be entitled to claim the "excluded home" exclusion for the whole property.

98. Officials consider that an apportionment approach, based on reasonable valuations, would be appropriate in this circumstance.

> ***Example***
>
> The Farmers own a 100 acre sheep farm. Approximately 1 acre of the land comprises the Farmers house, and gardens. The remainder of the property is devoted to business purposes.
>
> The Farmers are only entitled to claim the "excluded home" exclusion for the area comprising the house and gardens. When they sell the land, they obtain a valuation of the area comprising the house and gardens, compared to the rest of the property. The valuation confirms that the house and gardens make up approximately 15% of the value of the whole farm.
>
> On that basis, the Farmers are entitled to claim the "excluded home" exclusion for 15% of the total gain on sale.

5.6 What do other countries do?

99. For comparison purposes, Officials set out below a summary of how some other countries treat partial use of a residence.

Australia

100. Where a person partially uses their property for income earning purposes, apportionment of the net sales proceeds is required in line with Australia's interest deductibility rules. Where a person would have been entitled to claim an interest deduction if they had borrowed to acquire the property (whether or not they actually have an interest expense) they are not entitled to claim a full "main residence" exclusion. Instead, the person is required to apportion their net sale proceeds.

101. Where a business or professional practice is run in part of a home, an interest deduction is only allowed if part of the dwelling has the character of a place of business. This is a question of fact, but broadly depends on whether:

- part of the dwelling is set aside exclusively as a place of business and is clearly identifiable as such; and
- that part of the home is not readily suitable or adaptable for private use.

102. Interest deductibility, and therefore apportionment on sale, is not allowed/required where, for example, a home study is used to undertake work usually undertaken elsewhere, or a person does paid child-minding at home. In those cases the full "main residence" exemption applies.

103. Australia requires apportionment on a reasonable basis, usually based on floor area and period of income producing use.

Canada

104. Where a person starts using part of their "principal residence" for an income earning use, a deemed disposal and reacquisition will arise for that portion of the property (usually based on floor area) for market value. Where a person stops using part of their "principal residence" for an income earning use, and resumes using that part as their "principal residence", this will also result in a deemed disposal, giving rise to a taxable gain.

105. However, these rules only apply where the partial use is substantial and of a permanent nature (ie, gives rise to structural changes). No deemed disposal is required where the income producing use is ancillary to the main use of the property as a residence, there is no structural change (for example where the person carries on a business of caring for children, rents one or more rooms in the house, or has an office or other work space in the home), and no depreciation is claimed for the income producing use.

South Africa

106. Where part of a “primary residence” is used for carrying on trade, the exclusion will not apply to the portion of a capital gain or loss that relates to that part.

107. Apportionment between private and income earning use may be based on floor area (eg, when a portion of the residence is use for income earning purposes), or time (eg, when a primary residence is let out for a period). Apportionment may also be based on a combination of both time and area in appropriate cases.

United Kingdom

108. Where part of a building (which is used as a residence) is used exclusively for income earning purposes, only the part that is used as a residence will qualify for the “principal private residence” exemption (eg, if the property consists of living accommodation above a shop, or if a person lets part of their residence). A room that is used partly for business purposes and partly for residential purposes will qualify for relief in full, unless the residential use is very minor.

109. Apportionment between residential and business uses depends on what is “reasonable” based on the facts of each case, and is not necessarily based on the number of rooms or floor area.

110. There are also specific concessions where a person has a single lodger, or the person’s children or parents are paying board for the exclusive use of a room. In these cases, the whole property should still remain exempt.

6.0 Changes of use

6.1 Introduction

111. In Appendix B to the Interim Report, the Group said that rules will also need to be developed for circumstances where the owner of an excluded home moves out of the home, or the owner of a rental property or second home moves into the property so that it becomes an excluded home. As noted above, this paper refers to this partial use on a time basis as a "change of use".

112. The Group suggested two alternative approaches as follows:

- The change of use would result in a deemed sale and reacquisition of the property for market value; or
- Any gain on sale of the property could be apportioned based on the time used as an excluded home compared with the time used for income earning purposes.

113. Officials have considered options for dealing with this situation, taking into account methods used in other jurisdictions. This part of the paper provides comments on the three options. It also provides examples of how this would work in practice, for the Group to consider.

6.2 Options

114. Officials have identified three potential options for dealing with the change of use of an "excluded home", as follows:

- The first option is to require a deemed disposal of the property at the time the use of the property changes.
- The second option is to require apportionment of the net sale proceeds based on actual use of the property, on a straight line basis.
- The third option is to require apportionment of the net sale proceeds based on actual use of the property, on a valuation basis.

Deemed disposal

115. The first option for dealing with a change of use is to deem the owner of the property to have disposed of the property for market value immediately before the change of use, and to have reacquired the property for market value immediately after the change of use. Similar rules are included throughout the Income Tax Act 2007.[6]

116. The consequence of a deemed disposal is that:

- Where the property changes from being used as an "excluded home" to being used for an income earning purpose, the deemed disposal provides a

[6] See for example s DB 27 (Amount from major development or division and not already in income).

cost base, which will be allowed as a deduction when the property is ultimately sold.

- Where the property changes from being used for an income earning purpose to being used as an "excluded home", this would be treated as a sale that is subject to tax.

117. The main benefits of a deemed disposal approach are that it is accurate and timely. Because this approach is based on actual valuations, the tax payable will reflect the actual gain that has been incurred during the period the property is used for income earning purposes. It also ensures that tax is paid at the time when a change of use occurs.

118. However, this approach involves compliance costs for the taxpayer, because they are required to obtain valuations when they change the use of their property. In addition, in the case where a person moves into a property that they previously rented out, this option gives rise to a tax liability when the person has not actually received any cash, and so may not have the funds available to pay the liability.

119. One way to alleviate this effect could be to delay the actual payment of the tax until the property is eventually sold. However, that will delay the time that tax is received by Inland Revenue. This would also raise the question of whether there should be an interest charge for the deferral.

Apportionment – straight line

120. The second option is to apportion the net sale proceeds based on the total time the property was used for income earning purposes compared with the time the property was used as an excluded home, on a straight line basis. This would involve the sale proceeds simply being divided in accordance with the period of each type of use.

121. The benefit of this option is that it is simple to apply, and will entail low compliance costs for taxpayers.

122. However, such an approach forgoes accuracy, could lead to under or over taxation depending on market movements.

Apportionment – valuation basis

123. The final option is a hybrid deemed disposal/apportionment. Under such a method, the net sale proceeds would be apportioned on actual disposal, but based on the actual increases in value that occurred when the land was held for private versus income earning purposes.

124. The benefit with this option is that it is accurate. It also solves issues with the taxpayer's ability to pay that arise with a straight deemed disposal approach because the tax is not due until the property is sold.

125. However, this approach requires more compliance costs for the taxpayer as they will be required to obtain a valuation each time the property changes use. This

could be quite onerous if the use of the property changes multiple times during the period of ownership.

De minimis threshold

126. Officials note that the proposals above require every change of use to be counted when determining the application of the "excluded home" exclusion. However, consideration could be given as to whether a *de minimis* threshold could be provided for short-term absences (for example, a year or less). If this was the case then, provided the change to an income earning use was for a year or less, it would be ignored, and the property would be treated as an "excluded home" for the whole period it was held. This option would not be available if a person was claiming an "excluded home" exclusion for another property during this time.

6.3 Examples – Simple changes of use

127. The following examples illustrate how the various options will operate in practice in simple change of use scenarios.

Example 1 – Residence to rental

Peter purchases a property in 2010 for $500,000. He uses the property as his residence. In 2015, Peter moves out of the property and uses it as a residential rental property. At the time of the change of use, the property is valued at $600,000. In 2018, Peter sells the property for $700,000.

Deemed disposal

Under a deemed disposal approach, when Peter changes the use of the property from residential to rental, he is deemed to have disposed of, and reacquired, the property for its market value ($600,000). As the property was used as Peter's residence for this period, no tax will be payable on this deemed disposal because the "excluded home" exclusion will apply.

When Peter sells the property in 2018, the $600,000 will be the cost base of the property, which can be deducted from the sale proceeds ($700,000) to determine the taxable gain ($100,000).

Apportionment – straight line

Under the straight line apportionment approach, on sale of the property 5/8 of the net gain will be eligible for the "excluded home" exclusion because Peter used the property as a residence for a total of five of the eight years he owned the property:

$700,000 - $500,000 = $200,000 x 5/8 = $125,000

The remaining 3/8 of the net gain ($75,000) will be taxable income for Peter in the year of sale.

Apportionment – valuation basis

Under a valuation apportionment approach, when Peter sells the property he has a net gain of $200,000. $100,000 of that gain is attributable to the time that Peter used the property as his family home (ie, $600,0000 - $500,000). Because Peter lived in the property during this period, that portion of the gain will be subject to the "excluded home" exclusion.

The other $100,000 of the gain arose during the period that Peter used the property as a residential rental property. Therefore, that gain will be subject to tax in the year of sale.

Example 2 – Rental to residence

Sally purchases a property in 2010 for $400,000. She uses the property as a residential rental property. In 2014, Sally decides to move into the property and uses it as her family residence. At the time of the change of use, the property is valued at $550,000. In 2017, Sally sells the property for $675,000.

Deemed disposal

Under a deemed disposal approach, when Sally changes the use of the property from residential rental to her private residence, she is deemed to have disposed of, and reacquired, the property for its market value ($600,000). As the property was used as a rental property during this period, the deemed net sale proceeds will be subject to tax in 2014 (i.e., $550,000 - $400,000 = $150,000).

When Sally sells the property in 2017, no further tax will be payable because the "excluded home" exclusion will apply.

Apportionment – straight line

Under the straight line apportionment approach, on sale of the property 3/7 of the net gain will be eligible for the "excluded home" exclusion because Sally used the property as a residence for a total of three of the seven years she owned the property:

$675,000 - $400,000 = $275,000 x 3/7 = $117,857

The remaining 4/7 of the net gain ($157,143) will be taxable income for Sally in the year of sale.

Apportionment – valuation basis

Under a valuation apportionment approach, when Sally sells the property she has a net gain of $275,000. $125,000 of that gain is attributable to the time that Sally used the property as her family home (ie, $675,000 - $550,000). Because Sally lived in the property during this period, that portion of the gain will be subject to the "excluded home" exclusion.

The other $150,000 of the gain arose during the period that Sally used the property as a residential rental property. Therefore, that gain will be subject to tax in the year of sale.

Example 3 – Change of use on death

Brian owned a property in Christchurch where he lived since he purchase it in 2010. In 2018 Brian died. While winding up the estate, Brian's executors decide to rent the property out. The property is rented until it is sold in 2020.

Deemed disposal approach

Under a deemed disposal option Brian will be deemed to have disposed of the property on the date that his estate begins using it as a rental property. No tax will be payable by Brian's estate because the property was used as his "excluded home". The deemed disposal will give rise to a cost base, which can be deducted from the net sale proceeds when it is finally sold.

Apportionment – straight line

Under a straight-line apportionment option, Brian's estate would be required to pay tax on 2/10th of the total gain when he sell the property (because the property was used for income earning purposes for two out of the ten years it was owned by Brian (including the time it was held by his estate).

Apportionment – valuation basis

Under a valuation apportionment option, Brian's estate would be required to pay tax on the actual increase in value of the property while it was being used for income earning purposes, but would not have to pay the tax until the property was sold.

6.4 Examples - Temporary changes of use

128. Officials recommend that the same rules also apply to temporary changes of use. Officials consider that this approach better reflects the intention that a person should only be able to claim the "excluded home" exclusion for the period where they are using a home as their residence.

129. The following examples illustrate how the above options would apply to temporary changes of use.

> ***Example 1 – Moving for work reasons***
>
> Donald and Daisy occupy a family home in Auckland, which they purchased in 2010. In 2014, they temporarily move to Wellington for work reasons. Donald and Daisy purchase an apartment in Wellington where they live while they are there, but decide to keep their Auckland home while they are away, and rent it out.
>
> In 2017 Donald and Daisy sell their Wellington apartment and move back into their Auckland home. Donald and Daisy live in their home until 2021 when it is sold.
>
> *Deemed disposal*
>
> Under a deemed disposal option, Donald and Daisy would need to obtain a valuation for the property each time it changed use. They would be required to pay tax when the use changed back from rental property to family home in 2017. However, no tax would be due as a result of the first change of use, or on actual sale, because the "excluded home" exclusion would apply.
>
> *Apportionment – straight line*
>
> Under a straight-line apportionment option, Donald and Daisy would be required to pay tax on 3/11th of the total gain when they sell the property (because they used the property for income earning purposes for three of the 11 years they owned it).
>
> *Apportionment – valuation basis*
>
> Under a valuation apportionment option, Donald and Daisy would be required to pay tax on the actual increase in value of the property while it was being used for income earning purposes, but would not have to pay the tax until the property was sold.

> ***Example 2 – Moving overseas***
>
> Mickey and Minnie own a property in Dunedin, which they purchased in 2008 for $300,000. In 2012, Mickey and Minnie decide to go overseas on their OE. They are gone for two years, and during this time they rent out the property.
>
> In 2014 Mickey and Minnie return to their property. They occupy it as their residence until 2018 when they sell it and move to another property.
>
> *Deemed disposal*
>
> Under a deemed disposal option, Mickey and Minnie would need to obtain a valuation for the property each time it changed use. They would be required to pay tax when the use changed back from rental property to family home in 2014. However, no tax would be due as a result of the first change of use, or on actual sale, because the "excluded home" exclusion would apply.
>
> *Apportionment – straight line*
>
> Under a straight-line apportionment option, Mickey and Minnie would be required to pay tax on 2/10th of the total gain when they sell the property (because they used the property for income earning purposes for two of the 10 years they owned it).

Apportionment – valuation basis

Under a valuation apportionment option, Mickey and Minnie would be required to pay tax on the actual increase in value of the property while it was being used for income earning purposes, but would not have to pay the tax until the property was sold.

130. Officials note that there may be some concern that a person may not return to pay their tax if they move overseas. However, Officials note that it is proposed that a non-resident should be subject to tax on the sale of New Zealand land. The new withholding rules for sales of land subject to the bright-line rules by non-residents may be able to be extended to facilitate tax collection in this scenario.

Example – Empty home

Bill owns a property in New Zealand which he occupied as his residence since he purchased it in 2012. In 2015 Bill decides to move overseas for work. He intends to return to the property and does not want anyone to damage it while he is away so he leaves the property empty while he is away. Bill returns in 2018 and continues living in the house until 2020 when it is sold.

Deemed disposal

Under a deemed disposal option, Bill would need to obtain a valuation for the property each time it changed use. He would be required to pay tax when the use changed back from vacant to private home in 2018. However, no tax would be due as a result of the first change of use, or on actual sale, because the "excluded home" exclusion would apply.

Apportionment – straight line

Under a straight-line apportionment option, Bill would be required to pay tax on 3/8th of the total gain when he sell the property (because he did not live in the property for three out of the eight years he owned it).

Apportionment – valuation basis

Under a valuation apportionment option, Bill would be required to pay tax on the actual increase in value of the property while it was vacant, but would not have to pay the tax until the property was sold.

6.5 Officials' recommendations

131. Officials recommend the adoption of a straight line apportionment approach. Such an approach is simple to apply and involves relatively little compliance from taxpayers. While it is likely to over tax, or under tax, some people, Officials consider that simplicity should be preferred over accuracy in the context of the main home exclusion.

132. As noted above, Officials recommend that the same rules be adopted for all changes of use, whether temporary or not, and whether the property is used for income earning purposes, or is left vacant. However, Officials recommend consideration of *de minimis* rule for very short absences (for example, a year or less), where the absence will be ignored.

6.6 What do other countries do?

133. For comparison purposes, Officials set out below a summary of how some other countries treat changes of use.

Australia

134. If a person stops using a property as their "main residence", they can continue to treat the property as a "main residence" for up to six years if it is used to produce income, or indefinitely if it is not used to produce income. The six-year period does not need to be continuous, and intermittent periods may be aggregated.

135. If a person uses a property that was their "main residence" for income earning purposes for more than six years, then they are deemed to have disposed of the property for market value and reacquired it at the time they first started using the property for income earning purposes, to determine the cost base of the property.

136. The six year period applies separately each time a property becomes and ceases to be a person's "main residence".

Canada

137. In Canada, each person can designate a "principal residence" for each tax year. The gain on sale is apportioned based on the number of years for which the property was the person's principal residence, and during which the person was resident in Canada, as a proportion of the total years the person owned the property.

138. If a person completely converts their "principal residence" to an income-producing use, they are deemed to have disposed of the property at fair market value and reacquired it immediately for the same amount. However, the person can elect to defer recognition of the gain for up to four years, and continue to claim the "principal residence" exemption for that property during that time. If the person makes this election, they have to report the income from their income producing activity but cannot claim any depreciation on the property.

139. During the deferral period, the person will not be able to claim the "principal residence" exemption for any other property, and must be resident in Canada for tax purposes.

140. The deferral period can be extended indefinitely if:

- the person or their spouse or common-law partner's place of employment has been relocated;
- the employer is not a related person;
- the original property is at least 40km farther from the new place of employment than the person's new place of residence; and
- the person returns to live in their original property during the term of employment or before the end of the year after the employment ends.

141. If a person completely changes the use of their property from an income earning purpose to a “principal residence” they are deemed to have disposed of the property for fair market value and reacquired it immediately for the same amount, resulting in a taxable capital gain. The person can elect to defer recognition of the gain from the deemed disposal to a later year by filing a signed letter with their tax return. The election is not available if depreciation has previously been claimed for the property. Where a person makes an election to defer the recognition of the gain from the deemed disposal they can claim the “principal residence” exemption for up to four years prior to the change of use. A person can still only have one “principal residence” in any given tax year.

South Africa

142. Where a person changes the use of their “primary residence” to an income earning use, they are required to pay tax on part of their capital gain or loss when they dispose of their property. The amount of tax is determined based on the period that the property was used for the income earning purpose compared with the total period of ownership.

143. A person may be entitled to the “primary residence” exclusion for a period not exceeding two years when they are not ordinarily resident in that property, if:

- the property that was the person’s “primary residence” is being offered for sale and is vacated due to the acquisition of a new “primary residence”;
- the residence is being erected on land acquired to be a “primary residence”;
- the residence has been accidentally rendered uninhabitable (for example, because of fire); or
- the person has died.

144. In addition, a change of use from “primary residence” to letting will be ignored if:

- the residence is let for not more than five years;
- the property was used as a “primary residence” for at least one continuous year before and one continuous year after the period when the property was let;
- no other residence was treated as a “primary residence” during the period; and
- the person was temporarily absent from South Africa, or was employed or engaged in carrying on business at a location more than 250km from the residence.

United Kingdom

145. Where a person has changed the use of their property from private to income earning during the period it is held, any gain on sale is apportioned in a manner which is “just and reasonable”. Apportionment takes into account the extent to

which, and the period over which, each part of the property has been used as the owner's main residence.

146. In some cases where a person is temporarily absent from their property, they may still be treated as occupying their property. Provided they have used the property as their main residence at some time before and after the period of absence (unless they could not return to the residence because of their employment or their spouse or civil union partner's employment), the following temporary absences are treated as periods of actual occupation, rather than as a change of use:

- Absences for whatever reason, of not more than three years in total.
- Absences during which the person (or their spouse or civil union partner) is in employment and all their duties are carried on outside of the United Kingdom.
- Absences totalling not more than four years when the distance from the person's (or their spouse or civil union partner's) place of work prevents them from living at home and the employer reasonably requires the person to work away from their home.

147. However, a person is still only entitled to claim the "principal private residence" exemption in relation to one property at any one time, unless they are moving between residences.

148. When a person sells a property that they have previously used as their main residence, they are deemed to have used it as a residence during the last 18 months they owned it, even if it is not actually used for that purpose. Similarly, when a person acquires a property, they are treated as residing in that property for up to 12 months (or up to two years in exceptional circumstances) if they could not occupy it because they were unable to sell their old home, or refurbishment is needed. During this 12 month (or up to two year) period of overlapping ownership, relief is available for both residences.

Appendix A: Suggested text for Final Report

The "excluded home"

1. The Terms of Reference require that the Group excludes the family home and the land under it from any extension to the taxation of capital income. The Group notes that the Terms of Reference did not define a family home. It also notes that, while a gain on a family home (whether realised or not) does increase a person's wealth, generally speaking it does not increase the person's consumption potential as it simply represents a place to live and connect with their family. That is, it is their turangawaewae.

2. The family home in the Pākehā sense of the term is the house that is the centre of family connections for the individuals who live there. While the nuclear family (ie, parents and young dependent children) is the most common representation of family in New Zealand, even for Pākehā family is increasingly taking on broader connotations involving blended families (for example, grandparents raising grandchildren, and significant delay for adult children leaving to set up their own households). For Māori this concept is even broader.

3. To integrate this with the design of an extension of the taxation of capital income, the Group proposes that there be an exclusion for a property that is mainly used as residence for a person, or a person and any member of their family living with them (referred to as the "excluded home").

4. The rest of this section details the Group's recommendations of how to define an "excluded home".

Who can own an "excluded home"?

5. An "excluded home" can be a property owned separately or jointly by the person who uses it as a residence. An "excluded home" can also be:
   - a property owned by a trust, if a person occupying the property mainly as their residence is:
     - a settlor of the trust; or
     - a beneficiary of the trust who is irrevocably entitled to the property;
   - shares in a flat owning company, if a person who owns the shares occupies the property mainly as their residence; or
   - a property owned by an ordinary company or look through company, if the person who owns the shares occupies the property mainly as their residence.

6. Only New Zealand residents (who are treated under a double tax agreement as being resident in New Zealand) can have an "excluded home".

Only one "excluded home"

7. A person, or a person and their family living with them (a "family unit") can only have one "excluded home" at any one point in time. If a person or "family unit" has more than one property that is used mainly as a residence by them, they will be required to make an election as to which property is their "excluded home".

8. A "family unit" includes a person and the following persons (if any):
   - their spouse, civil union, partner or de facto partner, unless:
     - they are legally separated; or
     - they usually live in separate homes, that are owned individually by each of them;
   - their children under the age of 18 years; and
   - any other member of their extended family who is living with them.

9. The following examples illustrate how these definitions work:

> ***Example 1 – One "family unit"***
>
> Karen and her husband own a house in Wellington where they live with their two small children (ages 4 and 7). Karen and her husband also own an apartment in Auckland where Karen stays two to three days a week when she is working in Auckland. The family also spend approximately six weeks per year (during school holidays) living in the Auckland apartment as a family.
>
> Karen, her husband and their children are one "family unit". Therefore, they are only entitled to have one "excluded home". They will need to elect which property will be their "excluded home".

> ***Example 2 – Couple has separated***
>
> John and Trudy have been married for 10 years. During that time they lived together in a home they jointly own. Their relationship breaks down and they decide to separate. John remains in the home they shared, and Trudy purchases a new home.
>
> After their separation, John and Trudy can each have a separate "excluded home".

> ***Example 3 – Separate homes***
>
> Natalie and Sarah are married. However, they each own separate homes, and do not usually live together. Their personal property is kept separately in their respective separate homes.
>
> Natalie and Sarah can each have a separate "excluded home".

Exceptions

10. There would be two exceptions to the general rule that a person or "family unit" can only have one "excluded home".

11. Where a person or "family unit" purchases a new property, and is holding their old property for sale, both properties can be "excluded homes" for a short period. However, the original property must have been used mainly as the residence of the

person or "family unit", and the new property must be purchased with the intention that it will be used mainly as a residence for the person or "family unit" from the time of purchase. The old property must also remain vacant during the period that it is held for sale.

> ***Example – Sale and purchase***
>
> Kate and Will own a property that they have occupied as their "excluded home". They decide to move to another area. They find a new home, purchase it, and move into it. However, it takes three months to sell their old home. While it is on the market, the old home is left vacant.
>
> Kate and Will will be entitled to claim the "excluded home" exclusion for both homes for the three months that they own both.

12. When vacant land is purchased with the intention of building a home that will mainly be used as a residence of the person or "family unit", both the vacant land and another property that the person owns can be "excluded homes" for a short period. The other property that the person owns must be occupied by the person or "family unit" mainly as their residence, and the person or "family unit" must intend to occupy the new property mainly as their residence once the home is completed. Both properties cannot be "excluded homes" where the vacant land is held for a long period before it is occupied.

> ***Example 1 – Building a new home***
>
> Burt and Ernie have a home in central Wellington. They decide to purchase a vacant section in the outer suburbs and build a new home for themselves. It takes two years from the date of purchase of the vacant section for the new home to be built. During that time Burt and Ernie continue to live in their central Wellington home. Once the new home is completed, Burt and Ernie sell their central Wellington home and move into their new home.
>
> Both properties are "exclude homes" of Burt and Ernie for the two years that they owed both.

> ***Example 2 – Land banking***
>
> Jason and Kim have a family home that they have occupied for a number of years. They decide to purchase some vacant land, with the intention of building a new home for themselves. They hold the land for three years before they start to develop plans. Once they start to develop plans, it takes a further three years to complete the home. Once the new home is completed, Jason and Kim sell their old home and move into their new one.
>
> Six years is too long for the vacant land to be treated as an "excluded home".. Therefore, both properties will not be "excluded homes" for the whole period they are both owned by Jason and Kim.

13. The Group recommends that further consideration be given to the appropriate time period that two properties can both be treated as "excluded homes".

Land under an "excluded home"

14. The "excluded home" includes the land under the house, and the land around the house up to the greater of 4,500m^2, or the amount required for the reasonable occupation and enjoyment of the house.

15. Where the total area of the property is greater than 4,500m^2, or not required for the reasonable occupation and enjoyment of the house, the gain on sale will be apportioned on a reasonable basis.

> ***Example***
>
> The Farmers own a 100 acre sheep farm. Approximately 1 acre of the land comprises the Farmers house, and gardens. The remainder of the property is devoted to business purposes.
>
> Only the area of the house and gardens is part of the "excluded home".. When the Farmers sell the land, they obtain a valuation of the area comprising the house and gardens, compared to the rest of the property. The valuation confirms that the house and gardens make up approximately 15% of the value of the whole farm.
>
> On that basis, only 15% of the total gain on sale can be allocated to the "excluded home".

Māori freehold land

16. [Placeholder for a comment regarding the application of the "excluded home" exclusion to Māori freehold land].

Partial use of "excluded home" for income earning purposes

17. When a person uses part of their property for income earning purposes while they are also living in the property (eg, where there is a home office, a room is used for Airbnb, or where a person has flatmates), the entire property will still be an "excluded home" as long as it is "mainly" used as the person's residence. The Group proposes that "mainly" in this context will mean that the property is more than 50% used as a residence, and will take into account both the floor area used for income earning versus private purposes, and the time that the property is used for income earning purposes.

18. The following examples illustrate how this will apply:

> ***Example 1 – Home office***
>
> Gary owns a five bedroom house that he uses as a residence for himself and his family. He also runs a consulting business out of one room in his house. As the area of the house used for income earning purposes is minor, and the house is "mainly" used as a residence, the entire property is an "excluded home".

> ***Example 2 – Airbnb***
>
> Mary purchases a house, which she occupies as her main home. The house has two living areas, one of which has a small kitchenette. Mary decides to advertise the use of one of the bedrooms and the second living area with the small kitchenette (approximately 33% of the total floor area of her house) on Airbnb. Mary has paying guests staying in her house for an average of 50 days each year. Mary uses those areas for her own private use at other times of the year.
>
> Both the area used (33% of the floor area) and time the area was used for income earning purposes (an average of 50 days a year) amount to minor income earning use of the property. Therefore, the entire property is "mainly" used as a residence, and is an "excluded home".

> ***Example 3 – Flatmates***

Thomas owns a four bedroom house. In order to pay his mortgage, he rents two of the bedrooms (approximately 25% of the floor area of the house). He also shares the use of the living areas (33% of the floor area of the house) with his flatmates.

In this scenario, the living areas are being used simultaneously for both private purposes (ie, this is part of Thomas's residence) and for income earning purposes (as part of the area that is being rented out).

The Group considers that the property is "mainly" being used by Thomas as his residence. He has exclusive access to two of the four bedrooms and shared access to the living areas. Therefore, the entire property is an "excluded home".

19. However, the Group proposes that where there is an area of the house which is set aside exclusively for income earning purposes and cannot be used for private purposes (eg, as a doctor's surgery or dairy) then only the area that is used for private purposes will be an "excluded home". Any capital gain on sale would be apportioned, and the gain relating to the area of the house used for income earning purposes will be taxable.

Example – Doctor's surgery

George owns a two storey property. The front two rooms of the ground floor are set up as a doctor's surgery. The remainder of the house, including three more bedrooms, bathrooms, kitchen and living areas (approximately 65% of the floor area of the property), are used as George's family home.

Only 65% of the property is an "excluded home". The remaining 35% of the property is not an "excluded home" and any capital gain on sale will be taxable.

20. The Group proposes that, when a property is used "mainly" for income earning purposes, a person should be able to apportion the capital gain on sale and treat the part of the property used as a residence as an "excluded home".

Example 4 – Part of a larger building used for private purposes

Ruby owns a five bedroom property which she uses to run a bed and breakfast business. Ruby uses four of the bedrooms and most of the living areas for the bed and breakfast business. However, Ruby occupies one of the bedrooms and a small living area and bathroom attached to that bedroom as her residence (approximately 20% of the floor area of the property).

The 20% of the property that is used as Ruby's residence may be treated as an "excluded home", and Ruby would only have to pay tax on 80% of the gain on sale.

Changes of use

21. Where a person completely changes the use of their property, for example from a main residence to a rental property or vice versa, they will apportion the capital gain on sale in line with their actual use of the property.

22. The following examples illustrate how this would work in practice:

Example 1- Residential to rental

Peter purchases a property in 2020 for $500,000. He uses the property as his residence. In 2025, Peter moves out of the property and uses it as a residential rental property. At the time of the change of use, the property is valued at $600,000. In 2028, Peter sells the property for $700,000.

On sale of the property 5/8 of the net gain will be excluded from tax because the property was Peter's "excluded home" for five of the eight years he owned the property:

$700,000 - $500,000 = $200,000 x 5/8 = $125,000

The remaining 3/8 of the net gain ($75,000) will be taxable income for Peter in the year of sale.

Example 2 – Rental to residential

Sally purchases a property in 2020 for $400,000. She uses the property as a residential rental property. In 2024, Sally decides to move into the property and uses it as her family residence. At the time of the change of use, the property is valued at $550,000. In 2027, Sally sells the property for $675,000.

On sale of the property 3/7 of the net gain will be excluded from tax because the property was Sally's "excluded home" for a total of three of the seven years she owned the property:

$675,000 - $400,000 = $275,000 x 3/7 = $117,857

The remaining 4/7 of the net gain ($157,143) will be taxable income for Sally in the year of sale.

The Group proposes that the same rules will apply where a person dies, and the property is rented out while the estate is wound up. ***Example 3 – Change of use on death***

Brian owned a property in Christchurch where he lived since he purchase it in 2020. In 2028 Brian dies. While winding up the estate, Brian's executors decide to rent the property out. The property is rented until it is sold in 2030.

Brian's estate would be required to pay tax on 2/10th of the total gain when it sells the property (because the property was used for income earning purposes for two out of the ten years it was owned by Brian and his estate).

23. The Group proposes that apportionment will also apply where there is a temporary change of use. However, the Group is considering a possible *de minimis* rule for very short absences, where the absence will be ignored.

24. The following examples illustrate how this will work:

Example 4 – Moving for work reasons

Donald and Daisy occupy a family home in Auckland, which they purchased in 2020. In 2024, they temporarily move to Wellington for work reasons. Donald and Daisy purchase an apartment in Wellington where they live while they are there, but decide to keep their Auckland home while they are away, and rent it out.

In 2027 Donald and Daisy sell their Wellington apartment and move back into their Auckland home. Donald and Daisy live in their home until 2031 when it is sold.

Donald and Daisy would be required to pay tax on 3/11th of the total gain when they sell the property (because they used the property for income earning purposes for three of the 11 years they owned it).

Example 5 – Moving overseas

Mickey and Minnie own a property in Dunedin, which they purchased in 20208. In 2024, Mickey and Minnie decide to go overseas on their OE. They are gone for two years, and during this time they rent out the property.

In 2026 Mickey and Minnie return to their property. They occupy it as their residence until 2030 when they sell it and move to another property.

Mickey and Minnie would be required to pay tax on 2/10th of the total gain when they sell the property (because they used the property for income earning purposes for two of the 10 years they owned it).

Example 6 – Empty home

Bill owns a property in New Zealand which he occupied as his residence since he purchased it in 2022. In 2025 Bill decides to move overseas for work. He intends to return to the property and does not want anyone to damage it while he is away so it leaves his property empty while he is away. Bill returns in 2028 and continues living in the house until 2030 when it is sold.

Bill would be required to pay tax on 3/8th of the total gain when he sell the property (because he did not live in the property for three out of the eight years he owned it).

High value homes

25. In Appendix B to its Interim Report, the Group raised the possibility of applying a limit on the "excluded home" for higher value homes. This option is raised as a potential option for mitigating the "mansion effect", where people invest more capital in their family home where it can generate untaxed capital gains. Higher value homes also put pressure on the concept of family home and connotations of it being a place for a person primarily to live and connect with their family.

26. However, the Group considers this to be contrary to their terms of reference and so has not considered it further.

References

Canada Revenue Agency. (2017). *Capital Gain* (T4037(E) Rev. 17). Retried from http://www.canada.ca

Chow, M. (Ed.), (2018). *Australian Mater Tax Guide*. Sydney, CCH Australia Ltd.

Deutsch, R.L., Friezer, M.L., Fullerton, I.G., Hanley, P.J. and Snape, T.J. (2018). *Australian Tax Handbook 2018*. Sydney, Thomson Reuters (Professional) Australia Ltd.

HM Revenue & Customs. (2016). *Capital Gains Manual*. Retrieved from http://www.gov.uk

South African Revenue Service. (2017). Legal Counsel, Income Tax: Comprehensive Guide to Capital Gains Tax (Issue 6). Retrieved from http://www.sars.gov.za