Tax Working Group
Te Awheawhe Tāke

Tax Working Group Information Release

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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.

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Roll-over relief – non death

September 21, 2018

There needs to be consistency between roll-over on death and other roll-over. There can be differences in outcomes but there should be consistency with policy rationale. We thus need to reach a view on roll-over on death so that we can also reach a view on other roll-over.

Two forms of roll-over relief have been identified:

- Roll-over when property transferred and legal title changes but there is in substance insufficient change in economic ownership for this to be considered a realisation event.
- Roll-over where there is an in substance change in economic ownership (a sale at arm's length terms to a third party or equivalent) but the proceeds are reinvested so that it may be argued that the gain has not in substance been realised or at least not sufficiently realised to tax it. It seems to be common with overseas capital gains taxes for such roll-over relief to be provided and it is commonly referred to as "replacement property roll-over relief".

This is reflected in Labour's 2011 policy "Fairer Tax System": Roll-over relief "may apply where the transfer of an asset class is between taxpayer entities (e.g. from one arm of a business to another)." It "may also apply when a taxpayer disposes of one asset, and replaces it with a similar asset."

Insufficient change in economic ownership for this to be considered a realisation event.

The extent of roll-over relief under this heading seems largely determined by the extent to which roll-over relief is provided on death and following that by way of gifting.

As per prior note of 7 September, if there is unrestricted roll-over on death and gifting this automatically provides roll-over for transfers between individuals and trusts for less than market value. As per the prior note, if property is gifted, the transferor is deemed to have sold at its cost basis. The transferee adopts the transferor's cost basis. If it is sold below market value, the transfer is deemed to take place at the higher of the transferor's cost basis or the sale price (with the transferor taxed on any gain being the difference between costs base and transfer value). Only where property is sold for consideration resulting in a loss for the transferor does consideration need to be given to whether the sale price was at market value (in effect to disallow a deductible loss where the loss arises from a sale below market value).

As also per the prior note if there is restrictive roll-over on death this should flow through to the wider roll-over rules. Roll-over relief can be restricted by the relationship between the transferor and transferee and/or by the type of property being transferred.

As to transfers between companies, it would seem appropriate for roll-over relief to apply when property is transferred within 100% wholly owned groups parent/subsidiary or sister companies. This seems consistent with international practice. Outside 100% commonly owned groups transfers of property do seem to result in a transfer of in substance ownership since the underlining shareholder/owner changes and it would seem no roll-over should apply (unless a gift under gifting rules).

The issue then is when a sole shareholder transfers property to a company. The example is a farm transferred buy a farmer to a company owned by the farmer. This issue was discussed in Casey's note of 31 May 2018 "Roll-over relief for incorporation". The issues here seem complex and will be covered in a separate note.

Roll-over relief is provided in Australia for scrip for scrip takeovers and demergers. We should consider similar rules here.

There is then the issue of whether roll-over in these circumstances is compulsory or elective. Compulsory roll-over may be desirable for base maintenance – preventing property being legally transferred while in substance ownership does not change simply to crystallise a loss and thus a tax deduction. On the other hand roll-over cannot apply if the transferee is not informed of the transferor's cost basis. Presumably that should not be an issue for transfers within commonly company groups so that roll-over may be compulsory in such cases.

Agree or not – Roll-over relief should be available when property is transferred within a 100% owned company group.

Note – Need to consider separately transfer of property from an individual to a company owned by that individual.

Gain has not in substance been realised or at least not sufficiently realised to tax it.

This heading provides roll-over relief even when there has been a clear change in the economic ownership of the property but the consideration is not provided in a form that can be seen as being such that any gain can reasonably said to be realised.

Most countries seem to provide roll-over relief for what is generally termed the purchase of "replacement assets".

Where to draw the line

The first issue here is where to draw the line. In previous Group discussion there seems to have been general agreement that the compulsory purchase of land should give rise to roll-over relief especially if the compensation price is reinvested in a replacement asset. There seems a similar agreement that and gain on insurance proceeds on property destroyed should be entitled to roll-over relief. The argument here is that because the ongoing business realistically has to use the sale proceeds to replace the asset, the gain has not been realised sufficiently so that it should be taxable.

We have current law allowing this re Canterbury earthquakes.

On the other hand if normal trading stock is sold and the proceeds used to buy replacement trading stock current law provides no roll-over relief for replacement property – the business is taxable on gross profits from trading. It is doubtful there is any support for changing this. The argument here seems to be that trading stock is very liquid – it is intended to be bought and sold and the business is always free to run down its trading stock and turn it into cash.

It is suggested that the line drawing exercise be considered from the perspective raised in submissions of a farmer buying a small farm. The farmer then sells the farm to buy a larger farm and so on until he/she has built up a substantial farm. Submissions have argued that this is a normal way a new farmer builds up an economic farming unit. If tax is imposed on the gains each time a farm is sold, it has been submitted that this would impose a material barrier to those not inheriting farms being able to build up economic farming units over time. The gains from each farm sold presumably largely represent general increases in farm prices. The farmer needs this gain to enable him/her to buy the next farming unit that has also increased in value. Taxing the gain would mean that farmers increasing their operations would need to fund not only the increased farm size but tax on the gain from the sale of the former farm.

Note that taxing gains without indexation and at full rates would exacerbate this issue. The absence of roll-over relief would make New Zealand's tax rules stringent relative to many overseas capital gains tax regimes.

It is understood that there is support within the Group for roll-over relief in such a case. Indeed it seems that roll-over relief is often if not usually available for such cases in overseas capital gains taxes.

Agree or not there should be replacement property roll-over relief for farms sold and proceeds used to purchase another farm.

If roll-over relief is provided for farm sales and purchases then the same should presumably apply for SMEs and other businesses under a replacement property test. That would also apply to iwi entities that sell property and use the proceeds to reinvest in iwi assets. There would be a general replacement property roll-over relief for businesses. This would incorporate land compulsorily acquired under say the Public Works Act and proceeds from replacement insurance where the insurance payment exceeds the cost basis of the property.

Agree or not that replacement property roll-over relief should also apply to SMEs and iwi assets.

The issue then is where to draw the line – at what point does roll-over not apply when property is sold?

It is suggested that replacement property roll-over relief be limited to property held for the purpose of business use –that is property owned as part of a business. The rationale is that the replacement property roll-over relief is provided in recognition of the need for a business to replace assets used in that business and if asset prices generally increase then it cannot do so if tax is levied on such gains and the imperative to reinvest if the business is to be maintained means this should be treated for tax purposes in the same way as if property is simply held onto meaning no realization of the gain for tax purposes.

The exclusion of non-business assets from property roll-over relief means that investments outside of a business, for example portfolio share investments, would not benefit from replacement property roll-over relief. However, shares held by a parent in a subsidiary would be. The current business test is in effect the carrying of a profession, trade or undertaking with the intention of making a profit (*Grieve* (1984) 6 NZTC 61,682). It may be questionable as to whether renting residential property is a business (i.e. an "undertaking") as opposed to an investment. *Case G44* (1985) 7 NZTC 1,170 held it could be a business but *LD Nathan Property Group* (1980) 4 NZTC 61,602 suggests that renting is an investment activity not a business. The issue may need to be clarified at least for roll-over relief. Iwi assets should qualify for replacement property roll-over relief on the basis that provided the property is to continue to be held for the beneficiaries/iwi, then such property sold is equally unrealized in the sense that it needs to be reinvested. Whether iwi property would qualify as business assets would need to be clarified.

Agree or not that replacement property roll-over relief should be limited to business property (including iwi assets) but it should be clarified that residential house letting is not business property for these purposes.

It was suggested above that roll-over relief should not apply to trading stock even though trading stock is property held as part of a business. Trading stock is generally defined in section EB 2 of the Income Tax Act as property owned as part of a business for the purpose of sale or exchange in the ordinary course of the business. It excludes, inter alia, land and depreciable property.

Agree or not that replacement property roll-over relief should not apply to trading stock.

If the Group decides that there should be no replacement property roll-over relief for buying and selling farms (a judgement call) then this seems to imply a view that the sale of property to a third party is always a realization event giving rise to tax on any gains. The commercial necessity of reinvesting into a replacement asset does not obviate this conclusion. The same logic would suggest that compulsory acquisition or the receipt of insurance proceeds for the destruction of property equally gives rise to a taxable gain with the possible exception if the payment under a compulsory acquisition or insurance was required as a condition of receipt of payment to be used to purchase a replacement asset. The rule would then be that a gain is realised in all circumstances where there is a sale to a third party provided the transferor had a choice to retain the consideration as money's worth or (in the case of an exchange of property) turn the consideration into money's worth.

A general perusal of overseas capital gains tax rules suggests that this would be out of line with general overseas practice and very stringent relative to capital gains tax rules overseas.

Other requirements of replacement property roll-over relief

The rationale for replacement property roll-over relief is that the taxpayer has not realised the gain in the transferred property because that gain needs to be reinvested in the business as a matter of commercial reality.

The second issue in the design of such roll-over relief is to establish the requirements that need to be fulfilled for it to be considered that the gain needs to be reinvested in the business as a matter of commercial reality.

Similar overseas rules seem to require the taxpayer to establish an intention to reinvest. This seems subjective but presumably must be supported by objective facts. This might be supported by a requirement to reinvest in replacement property within a set period of time. Section CZ 25 re Canterbury earthquake requires reinvestment by the end of 2018/19 (nine years) but this was originally 2016/17 (seven years). In general I would be inclined not to have a time rule. If it can be objectively determined that the funds are not going to be reinvested in a replacement asset, then the roll-over relief ceases back to the year when it applied (with UOMI).

Agree or not that replacement property roll-over should require the taxpayer to establish an intention to replace the property from the realised gain.

Decide whether there should be a time limit by which time the replacement property is acquired.

There is also a need to determine what replacement property is. This could be quite restrictive – property of the same type – or not very restrictive – reinvestment in the same or similar business – or not restrictive at all – reinvested in business assets. Overall I would favour an unrestrictive rule because we should not want to tax incentivize people to invest in what not be the best choice and secondly because a “same or similar” test is likely to be fraught with boundary problems.

Agree or not that the replacement property does not need to be in the same or similar business provided it is a business asset (and not trading stock).

Robin Oliver