

**EXPOSURE DRAFT - FOR COMMENT AND DISCUSSION ONLY | HUKIHUKI HURANGA
- MŌ TE TĀKUPU ME TE MATAPAKI ANAKE**

Deadline for comment | Aukatinga mō te tākupu: **16 October 2023**

Please quote reference | Whakahuatia te tohutoro: **PUB00434**

Send feedback to | Tukuna mai ngā whakahokinga kōrero ki
Public.Consultation@ird.govt.nz

Notes | Pitopito kōrero: The Commissioner also plans to review QB (May 2005): GST consequences of a cancelled contract.

QUESTIONS WE'VE BEEN ASKED | PĀTAI KUA UIA MAI

Income tax – Forfeited deposits from cancelled land sale agreements

Issued | Tukuna:

QB XX/XX

This question we've been asked clarifies the circumstances in which a forfeited deposit from a cancelled land sale agreement is income to the seller.

Key provisions | Whakaratonga tāpua

Income Tax Act 2007 – ss CA 1, CB 1, CB 3, CB 6A – CB 23B, CZ 39, CZ40

Question | Pātai

Is a forfeited deposit from a cancelled land sale agreement income to the seller?

Answer | Whakautu

Yes, if one or more of these situations apply:

- A forfeited deposit is business income if the sale of the land that is the subject of the cancelled agreement was **part of the current operations of the business or an ordinary incident of the business** (s CB 1).
- A forfeited deposit is income from a profit-making scheme **if the seller is carrying on a profit-making scheme** that involves the sale of the land (s CB 3).
- A forfeited deposit is income under ordinary concepts **if it has the character of income** (s CA 1(2)). It will have the character of income if the proceeds of the sale would have been taxable (eg, under the land sales rules) had the sale gone ahead.

A forfeited deposit is not income to the seller under the land sale rules because there is no "disposal" of land if the agreement is cancelled and settlement and registration do not take place.

Key terms

Land sale rules – the land sale rules are in ss CB 6A to CB 23B, CZ 39 and CZ 40.

Settlement – the date the parties fulfil their contractual obligations for the sale of land (eg, the buyer pays the purchase price and the seller provides the buyer with the means of acquiring the title to the land).¹

¹ DW McMorland, *Sale of Land* (4th ed, Cathcart Trust, Auckland, 2022) at [11.01].

Explanation | Whakamāramatanga

Background

1. This question we've been asked explains the circumstances in which a forfeited deposit from a cancelled land sale agreement is income to the seller.
2. When parties enter into an agreement for the sale of land, the buyer often agrees to pay a deposit. The main function of the deposit is to guarantee performance.² A deposit is particularly important in land sale agreements, which often involve a delay between the date when the parties enter into the agreement and the settlement date. In New Zealand, a deposit is typically 10% of the purchase price.
3. If the sale goes ahead, the deposit is credited to the buyer on settlement as part payment of the purchase price. If the sale falls through due to the buyer's default the deposit is liable to be forfeited. This means the seller can retain the deposit for their own use. If the seller also claims damages, they need to give credit for the amount of the forfeited deposit.³
4. In the situation where the sale falls through and the deposit is forfeited, the seller needs to consider whether the forfeited deposit is taxable income. In this question we've been asked, we explain when a forfeited deposit is:
 - business income;
 - income from a profit-making scheme; or
 - income under ordinary concepts.
5. We also explain why a forfeited deposit is not income under the land sale rules. However, it is important to note that if proceeds from an agreement for the sale of land would have been taxable under the land sale rules if the sale had gone ahead then it is likely that a forfeited deposit arising from the cancelled agreement will be income to the seller under one of the categories listed above.

Business income

6. A forfeited deposit will be business income (s CB 1) if the seller:

² *Howe v Smith* (1884) 27 ChD 89 (UKCA); *Soper v Arnold* (1889) 14 App Cas 429 (HL); *Garratt v Ikena* [2002] 1 NZLR 577 (CA).

³ *Ng v Ashley King (Developments) Ltd* [2010] EWHC 456 (Ch), [2010] 4 All ER 914; *Shuttleworth v Clews* [1910] 1 Ch 176.

- is in business; and
- derives the forfeited deposit from the business.

Is the seller in business?

7. *Grieve v CIR* (1984) 6 NZTC 61,682 sets out the test for whether a business exists. Applying this test involves considering the nature of the taxpayer's activities and whether the taxpayer has an intention to make a profit. The factors to consider in determining whether a business exists include:
 - the nature of the activity;
 - the period over which the activity is carried on;
 - the scale of operations and volume of transactions;
 - the commitment of time, money and effort;
 - the pattern of activity; and
 - the financial results.
8. *Grieve* also states it may be helpful to consider whether the operations involved are of the same kind and are carried on in the same way as those that are characteristic of ordinary trade in the line of business in which the activity is conducted. However, in the end, it is the character and circumstances of the particular activity that are crucial.
9. *Grieve* notes that, while the taxpayer's statements about their intentions are relevant, actions will often speak louder than words.
10. If the seller is in business, the next question is whether they derive the forfeited deposit from their business.

Does the seller derive the forfeited deposit from their business?

11. A seller will derive a forfeited deposit from their business if the forfeited deposit:
 - has a nexus (connection) with the business activity; and
 - is revenue in nature.
12. The amount the seller derives must be connected to the business activity. Business income does not include amounts that are private in nature. For example, if a sole trader receives a forfeited deposit in the context of a private land sale rather than a business land sale, the forfeited deposit will not be business income.
13. The key question is whether the forfeited deposit is revenue (income) in nature. An amount will be revenue in nature if the person derives it from the current operations of

the business or in the ordinary course of business.⁴ This includes an amount that they derive from a transaction that is an ordinary incident of the business although not its main activity.⁵ An amount that is capital in nature is not income from a business.⁶

14. To determine whether an amount is income from a business, it is necessary to consider the nature of the business and how the transactions producing the amount are related to the conduct of the business.⁷
15. For example, if a person is a property dealer or developer, then the sale of land that they have acquired for the purpose of that business is part of the ordinary business of that taxpayer. It is the way the business earns its income. Land acquired for the purpose of the business is held on revenue account and when it is sold the proceeds from the sale are business income (and therefore taxable under either s CB 1 or CB 7).
16. If the sale of the land falls through due to the buyer's breach and the seller retains the deposit, then in the Commissioner's view the deposit is also part of the ordinary business of the seller and is revenue in nature. The transaction (the sale of the land) is part of the current operations of the business and the forfeited deposit is an amount arising from that transaction. The deposit is something that the parties have agreed to as part of their negotiations and the possibility that it may be forfeited if the buyer defaults is a contemplated outcome of the transaction. The chance that the sale may fall through is a risk that is part of the ordinary course of doing business that involves transacting in land. Example 1 illustrates this situation.
17. The same analysis applies if selling land is an ordinary incident of the business although not its main activity. A forfeited deposit arising from the (attempted) sale of that land would similarly be revenue in nature and income to the seller under s CB 1.
18. If a person in business holds land on capital account, then proceeds from the sale of that land are not income from a business. An example of land that is generally held on capital account is business premises.
19. If a person in business sells land that is held on capital account, the sale falls through due to the buyer's breach and the seller retains the deposit, then in the Commissioner's view the forfeited deposit will also be of a capital nature. Just as the sale of the land is not part of the current operations (or an ordinary incident) of the business, a forfeited deposit arising from an agreement to sell that land is not part of

⁴ *CIR v City Motor Service Ltd; CIR v Napier Motors Ltd* [1969] NZLR 1,010 (CA); *AA Finance Ltd v CIR* (1994) 16 NZTC 11,383 (CA).

⁵ *AA Finance Ltd v CIR; CIR v Rangatira Ltd* (1995) 17 NZTC 12,182 (CA).

⁶ Section CB 1(2).

⁷ *AA Finance Ltd v CIR*.

the current operations (or an ordinary incident) of the business. Example 2 illustrates this situation.

Example | Taura 1 – Forfeited deposit is business income

Instant Homes Ltd is a property developer. It regularly purchases land, builds houses or renovates existing properties for sale with the intention of making a profit. Recently the company purchased a property, built a home on it and sold it to Mr Brown. Mr Brown paid a 10% deposit but was unable to pay the balance of the purchase price on settlement date. Instant Homes Ltd cancelled the agreement and retained the deposit.

The forfeited deposit is business income to Instant Homes Ltd under s CB 1. Instant Homes Ltd is in business and it derives the forfeited deposit from the business. The sale of the land is part of the ordinary business of Instant Homes Ltd and the receipt of the forfeited deposit is an amount which arises from that transaction. The possibility that the sale may fall through and the deposit may be forfeited if Mr Brown defaults is part of doing business as a property developer and a contemplated outcome of the transaction.

Example | Taura 2 – Forfeited deposit is not business income

Gorgeous George Ltd operates a hair salon. The company owns the land and building where the salon is located. Gorgeous George Ltd is doing well and decides to move to bigger premises so it can accommodate more stylists. Gorgeous George Ltd sells its existing property to Ju's Music Ltd. Ju's Music Ltd pays a 10% deposit but is unable to pay the balance on settlement date. Gorgeous George Ltd cancels the agreement and retains the deposit. The sale of the land would not have been taxable under the land sale rules.

The forfeited deposit is not business income to Gorgeous George Ltd under s CB 1. The sale of its business premises is the sale of land that is held on capital account. The sale of the land does not form part of the ordinary business of the company and is not an ordinary incident of the income-producing process. Just as the sale of the land is not part of the current operations of the business, a forfeited deposit arising from the agreement to sell the land is not part of the current operations of the business.

Income from a profit-making scheme

20. A forfeited deposit will be income from a profit-making scheme (s CB 3) if the seller:
- is carrying on or carrying out a profit-making undertaking or scheme; and

- derives the forfeited deposit from the profit-making undertaking or scheme.⁸

Is the seller carrying on a profit-making scheme?

21. For a forfeited deposit to be income from a profit-making scheme, the seller of the land must be carrying on a profit-making scheme that involves the sale of that land.
22. Essentially an undertaking or scheme is a series of steps directed to an end result. It needs to have a plan or purpose that is coherent and has some unity of conception. The dominant purpose of entering into or creating an undertaking or scheme must be to make a profit.⁹
23. If the seller has entered into a scheme involving the sale of land for the purpose of making a profit (ie, the land is held on revenue account) and the seller receives a forfeited deposit, the scheme is clearly underway and in the process of being carried on or carried out. The next question is whether the seller derives the forfeited deposit from the scheme.

Is the forfeited deposit derived from the profit-making scheme?

24. For a forfeited deposit to be derived from a profit-making scheme, the scheme must have a nexus (connection) with the forfeited deposit. This connection confirms that the forfeited deposit is in fact derived from the carrying on of the scheme rather than from something else (eg, chance).¹⁰
25. In the Commissioner's view, a forfeited deposit will have the necessary connection to a profit-making scheme involving the sale of land for the following reasons:
 - The possibility that the seller could retain the deposit is a contemplated outcome of the scheme. It is not unintended or derived in an unexpected way. Although the sale of the land is the preferred outcome and this alternative outcome may have a low probability of occurring, a forfeited deposit is nevertheless an outcome that is contemplated under the scheme and the contract of sale provides for it.
 - Cancellation of the contract does not mean the scheme has come to an end or been abandoned. The seller still owns the land and can continue with the scheme and sell the land to someone else.

⁸ For simplicity, where this item refers to "carrying on" it includes both "carrying on" and "carrying out" and where it refers to a profit-making "scheme", it includes an "undertaking".

⁹ *Investment & Merchant Finance v FCT* (1970) CLR 177 (HCA); *Vuleta v CIR* [1962] NZLR 325 (SC); *Duff v CIR* (1982) 5 NZTC 61,131 (CA); and *Case S86* (1996) 17 NZTC 7,538 (TRA).

¹⁰ *Duff v CIR*; J Prebble, *The Taxation of Property Transactions* (Butterworths, Wellington, 1986) at 47.

- Even if the seller decides to abandon the scheme following the cancellation of the sale, this does not detract from the fact that the seller received the forfeited deposit under a contract for the sale of land that the parties entered into as part of the scheme (ie, when the scheme was being carried on or out).
26. In summary, where a person is carrying on a profit-making scheme involving the sale of land, it is the Commissioner's view that a forfeited deposit received under a contract for the sale of that land will also be derived from the scheme and will be income to the seller under s CB 3. Example 3 illustrates this situation.

Example | Taura 3 – Forfeited deposit is income from a profit-making scheme

Conor is an accountant who lives in Auckland. In 2017 he purchased some bare land near Wanaka with the intention of building a home on it and moving there permanently.

However, circumstances changed and Conor decided to stay in Auckland. He decided to subdivide the Wanaka land into four lots, provide services to each property and do some work to make the sections attractive to potential purchasers who might like to build a home there. This included clearing the land, significant earthworks to construct building platforms, putting in driveways, fencing and letterboxes and grassing the land. Connor hired a project manager to arrange for the work to be done.

The development was finished in early 2023 and Connor put the sections on the market. He received an unconditional offer from Ambrosia for one section and she paid a 10% deposit. However, Ambrosia changed her mind about building a home and did not pay the balance of the purchase price on settlement date. Conor cancelled the agreement and retained the deposit.

The forfeited deposit is income to Connor under s CB 3. Connor is carrying out a profit-making scheme. He has a coherent plan to develop the land and sell it for a profit. The forfeited deposit is connected to the profit-making scheme – the fact that a sale might not be completed it is a contemplated outcome of the scheme and the contract of sale provides for it.

Income under ordinary concepts

27. If a forfeited deposit from a land sale agreement is not income from a business or a profit-making scheme, then it may be income under ordinary concepts (s CA 1(2)).

28. Income is something that comes in.¹¹ A forfeited deposit is an amount that “comes in” to the seller. It is generally a payment of money that the seller is entitled to retain on cancellation of the contract due to the buyer’s breach (assuming the buyer cannot obtain relief from forfeiture).
29. Whether a forfeited deposit from a land sale agreement is income under “ordinary concepts” depends on whether it has the character of income. The question is what is the nature of the forfeited deposit in the hands of the seller?¹² Resolving this question involves considering the relationship between the buyer and the seller and the purpose of a forfeited deposit (ie, what the payment is for).
30. In *Reid v CIR* the Court of Appeal said that the major determinant in many cases is the periodic nature of a payment (ie, whether it is recurrent or regular). A forfeited deposit is generally a one-off payment. Although a one-off payment is not typically indicative of income, it does not prevent it from having the character of income.¹³
31. An amount that is capital in nature is not income under ordinary concepts.¹⁴

The nature of a forfeited deposit

32. The main function of a deposit in a land sale agreement is to act as a guarantee that the buyer will perform the contract. In other words, it is a guarantee that the buyer will complete their part of the contract and pay the balance of the purchase price to the seller on the agreed date.
33. If the sale goes ahead the deposit is treated as part payment of the purchase price. If the buyer defaults and the deposit is forfeited, the Commissioner’s view is that the forfeited deposit is compensation for the failure of the buyer to pay the balance of the purchase price on settlement as promised. *Coumat Ltd v Whitford Properties Ltd* [2018] NZCA 15 supports this view. In that case, the Court of Appeal stated that a forfeited deposit of \$1.25 million was compensation for the failure of the buyer to settle.¹⁵

¹¹ *Tennant v Smith* (1892) 3 TC 158 (HL).

¹² *Reid v CIR* (1985) 7 NZTC 5,176 (CA).

¹³ *FCT v Cooling* 90 ATC 4472 (FCAFC); *FCT v Hyteco Hiring Pty Ltd* 92 ATC 4694 (FCAFC); *FCT v Dixon* (1952) 10 ATD 82 (HCA); *FCT v Myer Emporium* 87 ATC 4363 (HCA).

¹⁴ This is considered implicit in both s CA 1(2) and in *Reid v CIR* and is confirmed in *Case S86* (1996) 17 NZTC 7,538.

¹⁵ The Court of Appeal’s decision in *Garratt v Ikeda* provides implicit support for this view. Further support that a deposit is compensation in nature comes from *Polyset v Panhandat Ltd* [2002] 3 HKLRD 319 (HKCFA) and *Société Thermale d’Eugénie-les-Bains v Ministère de l’Économie, des Finances et de l’Industrie* [2007] 3 CMLR 38 (ECJ)

[44] The receipt of the \$1.25 million can be seen as a legitimate benefit enjoyed by Whitford and not as a gratuitous windfall. The deposit had been a pledge for the performance of the Initial Tender Agreement, and can also be seen as an aspect of the price of the option to obtain the sale. Mr Allen had expressly agreed to the forfeiture upon failure to settle when he signed the Initial Tender Agreement. Whitford had, after all, lost the benefit of the sale, and Mr Allen had not honoured his pledge. The forfeiture was compensation for this failure, provided for in the contract.

34. A forfeited deposit does not replace a claim for breach of contract. The seller can retain a deposit and also make a claim for damages. However, the seller must give credit for the amount of the deposit and can only claim damages in excess of this amount. In the Commissioner's view, the fact that the seller gives credit for the amount of the deposit in a claim for damages supports the view that a deposit is compensatory in nature.
35. The Commissioner is aware of the argument that a forfeited deposit is a penalty (rather than compensation).¹⁶ This argument arises because of uncertainty over the interaction between the law on deposits and the penalty rule, which have historically developed separately.¹⁷ The Commissioner considers that the better view is that a reasonable deposit is not a penalty.¹⁸
36. In summary, the Commissioner's view is that a forfeited deposit is compensation for the failure of the buyer to settle. It is not a penalty.¹⁹

Does a forfeited deposit have the character of income in the hands of the seller?

37. Compensation payments take the character of what they replace.²⁰ Applying the general principles from *London and Thames Haven Oil Wharves Ltd v Attwooll*, the relevant questions are:

¹⁶ DW McMorland, *Sale of Land* (4th ed, Cathcart Trust, Auckland, 2022) at [12.60].

¹⁷ A deposit is inherently liable to forfeiture (as long as it is reasonable) even if the seller suffers no loss. The traditional penalty rule is the rule that an amount payable on breach of a contract is unlawful as a penalty unless it can be justified as liquidated damages.

¹⁸ Support for this view comes from *Linggi Plantations Ltd v Jagatheesan* [1972] 1 MLJ 89 (PC); *Workers Trust & Merchant Bank Ltd v Dojap Investments Ltd* [1993] 2 All ER 370 (PC); *Simanke v Liu* (1994) 2 NZ ConvC 191,888 (HC); *Polyset v Panhandat*; *Garratt v Ikeda*; *Cavendish Square Holding BV v EL Makdessi*; *ParkingEye Ltd v Beavis* [2016] 2 All ER 519 (UKSC). *Cavendish* has been adopted in NZ in *127 Hobson Street Ltd v Honey Bees Preschool Ltd* [2020] 1 NZLR 179 (NZSC).

¹⁹ In reaching this conclusion, the Commissioner assumes that a deposit that has been forfeited is a reasonable deposit.

²⁰ *London and Thames Haven Oil Wharves Ltd v Attwooll* [1967] 2 All ER 124; *Burmah Steamship Co Ltd v CIR* (1930) 16 TC 67.

- What is the compensation paid for?
 - If the compensation is paid for the failure to receive an amount of money, then would that amount of money have been income to the recipient?
38. The compensation is treated for income tax purposes in the same way as the amount would have been treated if the seller had received that amount instead of the compensation.
39. In answer to the first question, in the situation where the buyer defaults and the seller retains the deposit, the deposit is a fixed amount of compensation that the buyer pays for their failure to perform the contract. While the seller still owns the property and can resell it, the parties have agreed under the contract for the sale of the land that the seller has the right to retain a fixed amount of money (the deposit) if the buyer defaults. The deposit was paid and forfeited because the seller did not receive the balance of the purchase price.
40. The answer to the second question depends on the circumstances of the seller. If, for example, proceeds from the sale of the land would have been taxable under the land sale rules, then the forfeited deposit is compensating for a loss of a revenue nature and will have the character of income. As the amount has the character of income, it will be income under ordinary concepts and taxable under s CA 1 (see Example 4 and Example 5).
41. If proceeds from the sale of the property would not have been taxable income to the seller, then the forfeited deposit is compensating for a loss of a capital nature. In this case the forfeited deposit will not have the character of income and will not be income under ordinary concepts. An example of this situation is where the sale would not have been taxable because the main home exemption in the land sale rules applies (see Example 6).

Example | Taura 4 – Forfeited deposit is income under ordinary concepts

Lucia bought a residential rental property on 1 August 2020. On 1 October 2022 she entered into an unconditional contract to sell the property to Gino. Gino paid a deposit of 10% and the balance was due on 1 December 2022.

Gino changed his mind about buying the property and did not pay the balance of the purchase price on the due date. Lucia cancelled the agreement and retained the deposit.

The forfeited deposit is income under ordinary concepts and therefore taxable under s CA 1(2). It has the character of income because the proceeds of the sale would have been taxable under the bright-line test in s CB 6A if the sale had gone ahead. Lucia

has lost the benefit of the sale and the buyer has failed to pay the purchase price on the settlement date. The forfeited deposit is compensation for Lucia not receiving an amount of a revenue nature.

Example | Taura 5 – Forfeited deposit is income under ordinary concepts

Phil heard from his friend Kelly that there was a new beachside subdivision being done where in Kelly's opinion the sections were going to be in hot demand. Phil bought one of the sections with the intention to on-sell it for a profit. He did not make any improvements to the section and listed it for sale.

Phil entered into a contract to sell the land to Jess. Jess paid a deposit but then changed her mind about buying the property and did not pay the balance of the purchase price on the due date. Phil cancelled the agreement and retained the deposit.

The forfeited deposit is income under ordinary concepts and therefore taxable under s CA 1(2). It has the character of income because the proceeds of the sale would have been taxable under s CB 6 if the sale had gone ahead because Phil acquired the land with the intention of selling it. Phil has lost the benefit of the sale and the buyer has failed to pay the purchase price on the settlement date. The forfeited deposit is compensation for Phil not receiving an amount of a revenue nature.

Example | Taura 6 – Forfeited deposit is not income under ordinary concepts

Maia and Nikau recently bought their first home. Then Maia got a job offer in a different city and they decided to sell their house and move. They entered into an unconditional contract to sell their home to Joon, who paid a 10% deposit.

Joon got into financial difficulty and failed to pay the balance on settlement date. Maia and Nikau cancelled the agreement and retained the deposit.

The forfeited deposit is not income to Maia and Nikau. If the sale had gone ahead, the proceeds from the sale would not have been taxable. Although the sale is within the relevant bright-line period, proceeds from the sale of the home would not have been taxable because of the main home exemption from the bright-line test in the land sale rules. The forfeited deposit is compensation for the failure of the buyer to pay the purchase price on settlement date. The forfeited deposit does not have the character

of income because it is compensation for Maia and Nikau not receiving an amount of a capital nature.

Income under the land sale rules

42. The land sale rules treat amounts derived from the disposal of land as income in various situations.²¹ These rules include the bright-line test. Each of these rules has different requirements that need to be met for an amount to be income but they all require a disposal of land. If there is no disposal of land, an amount cannot be income under these rules.
43. In the context of a forfeited deposit, the question is whether there is a disposal of land if a land sale agreement is cancelled and title does not pass. Answering this question involves considering the meaning of "land" for tax purposes and what "disposal" means in a tax context.
44. For tax purposes, the definition of "land" covers both a legal interest in land and an equitable interest, including where that interest is contingent.²²
45. Inland Revenue's position on the meaning of "disposal" in the land sale rules is that it requires complete alienation of the land by the disposer the land must be 'got rid of' by the person.²³
46. Therefore, in the context of a forfeited deposit, the question is whether the seller has disposed of a legal or an equitable interest in land during the period beginning with the making of the contract and ending on the cancellation of the contract.

Has the seller disposed of a legal interest in land?

47. Legal ownership in land is transferred when the document that evidences the buyer's right to legal ownership is registered.²⁴ Typically the transfer is registered electronically at the time of settlement.
48. If a land sale agreement is cancelled due to the buyer's default, then settlement and registration do not take place. Without registration, there is no transfer of legal ownership. It is clear in this situation that the seller has not disposed of a legal interest

²¹ Sections CB 6A to CB 15

²² See the definitions of "land" and "estate or interest in land" in s YA 1.

²³ [IS 22/03](#): Income tax – Application of the land sale rules to co-ownership changes and changes of trustees, *Tax Information Bulletin* Vol 34, No 7 (August 2022): 17.

²⁴ Section 24 of the Land Transfer Act 2017.

in land. No alienation of the legal title by the seller has occurred. The seller holds the legal title throughout the period of the agreement.

Has the seller disposed of an equitable interest in land?

49. An equitable estate or interest in land is an interest in land that is recognised and enforceable under the rules of equity.
50. To understand whether the seller has disposed of an equitable interest in land, it is helpful to consider the interests of both the buyer and the seller during the sale process and how those interests relate to each other.
51. In most land sale agreements, the buyer has an equitable interest in land from the time a binding contract exists.²⁵ This means that equity recognises the buyer has acquired rights that should be protected in an appropriate manner.²⁶ The buyer's equitable interest is conditional on them making the full payment of the purchase price.²⁷
52. In *Whiteleigh Holdings (New Zealand) Ltd v Whiteleigh Pacific Resources Ltd* (1987) 8 NZCPR 598, McGechan J identified that an unpaid seller retains a contingent interest in the equitable estate that passes to the buyer.²⁸

The equitable estate passing to the purchaser passes only upon a conditional basis. It passes and is received upon condition that the purchaser subsequently complete the agreement by paying the full purchase price. **Pending completion therefore the vendor holds a contingent interest in the equitable estate which is passed to the purchaser.** In the contingency that the contract is not completed, or becomes inequitable of specific performance, he will again become owner of that equitable estate. The existence of such a contingent interest in the equitable estate follows as an inevitable consequence of the established rules as to that which occurs in the event of the contingency. [Emphasis added]

53. On the basis that the seller holds a contingent interest in the buyer's equitable estate until the buyer pays the purchase price in full, the Commissioner's view is that the seller has not completely alienated the equitable interest in the land. The seller has not 'got rid of' the equitable interest completely because they still have an interest in the buyer's equitable estate.
54. While the definition of "land" includes a contingent equitable interest in the land, the Commissioner's view is that an equitable interest has not been disposed of (ie,

²⁵ *Bevin v Smith* [1994] 3 NZLR 648 (CA).

²⁶ *Bevin v Smith*.

²⁷ *Shaw v Foster* (1871–72) LR 5 HL 321; *Bevin v Smith*.

²⁸ In *Bevin v Smith* the Court of Appeal said that the identification of a contingent equitable interest of an unpaid vendor in *Whiteleigh Holdings* was consistent with its view.

completely alienated) where the seller retains a contingent interest in the purchaser's equitable interest.

Conclusion on the land sale rules

55. The Commissioner's view is that in the situation where a land sale agreement is cancelled due to the buyer's default, and settlement and registration do not take place, then there is no disposal of land for the purpose of the land sale rules. As there is no disposal of land, a forfeited deposit is not income under the land sale rules.
56. However, in the situation where proceeds from the sale of land would have been income under the land sale rules if the sale had gone ahead, the seller should consider whether the forfeited deposit is business income ([6] to [23]), income from a profit-making scheme ([24] to [30]) or income under ordinary concepts ([31] to [45]).

Draft items produced by the Tax Counsel Office represent the preliminary, though considered, views of the Commissioner of Inland Revenue.

In draft form these items may not be relied on by taxation officers, taxpayers, or practitioners. Only finalised items represent authoritative statements by Inland Revenue of its stance on the particular issues covered.

References | Tohutoro

Legislative references | Tohutoro whakatureture

Income Tax Act 2007: ss CA 1, CB 1, CB 3, CB 6A – CB 23B, CZ 39 – CZ 40, EB 2, YA 1 "estate or interest in land", "land", "trading stock"

Land Transfer Act 2017: s 24

Case references | Tohutoro kēhi

127 Hobson Street Ltd v Honey Bees Preschool Ltd [2020] NZSC 53; [2020] 1 NZLR 179

AA Finance Ltd v CIR (1994) 16 NZTC 11,383 (CA)

Bevin v Smith [1994] 3 NZLR 648 (CA)

Burmah Steamship Co Ltd v CIR (1930) 16 TC 67

Case S86 (1996) 17 NZTC 7,538 (TRA)

Cavendish Square Holding BV v EL Makdessi; ParkingEye Ltd v Beavis [2016] 2 All ER 519 (UKSC)

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