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IS 07/01: GST TREATMENT OF SALE OF LONG-TERM RESIDENTIAL RENTAL PROPERTIES

This interpretation statement replaces public ruling BR Pub 97/12, which was published as "Sale of long-term residential properties—GST implications" *Tax Information Bulletin* Vol 9, No 13 (December 1997), and applied until 31 March 2001.

Summary

1. All legislative references are to the Goods and Services Tax Act 1985 unless otherwise stated.

2. Under section 14(1)(d) the following supplies are exempt from GST.

   - The sale, in the course or furtherance of a taxable activity, of a property used by the supplier for the purpose of providing residential accommodation by way of rental, service occupancy agreement or licence ("residential rental purposes"), if the property has been used by the supplier exclusively for that purpose for a period of not less than five years up to the date of sale.

   - The sale in the course or furtherance of a taxable activity of a reversionary interest in land that has been leased by the supplier for the principal purpose of residential accommodation by way of rental, service occupancy agreement or licence in a dwelling erected on that land, if the land has been used by the supplier exclusively for that purpose for a period of not less than five years up to the date of sale.

3. As section 14(1)(d) applies only to sales made in the course or furtherance of a taxable activity carried on by the vendor of the property, if the sale is not made in the course or furtherance of a taxable activity, it is not necessary to consider whether section 14(1)(d) could apply to exempt the sale from GST.

4. Section 14(1)(d) will not apply to the sale of a property acquired for the principal purpose of a taxable activity of property development where the principal purpose in respect of the property remains unchanged and the principal purpose continues to be the ultimate sale of the property. In such circumstances, the property would continue to be used for a property development activity, in the sense that the owner obtains an advantage from retaining the property for sale in carrying on that activity. That being the case, the property would not be used exclusively for residential rental purposes and section 14(1)(d) would not apply to exempt the sale of the property. This is so even though on a time and space basis 100 percent of the property has been used for residential rental purposes for a period of five years before the sale of the property.

5. For section 14(1)(d) to apply, the *vendor* must have used the property exclusively for residential rental purposes for not less than five years up to the date of sale. It would not be sufficient that the property had been rented out for that period by different owners. However, the property need not be occupied by the same tenant throughout the five-year period.

6. For the purpose of calculating the five-year period, a property will continue to be used for residential rental purposes even if it was vacant for periods during the five years while attempts were made to rent out the property as residential accommodation: *Schwerzerhof v Wilkins* [1898] 1 QB 640.

Background

7. Generally, the sale of a residential rental property (a property that has been used for residential rental purposes) is not subject to GST. This is because the provision of residential accommodation under any such arrangement is exempt from GST; therefore, the sale of a residential rental property is not in the course or furtherance of a taxable activity. However, in some circumstances a residential rental property may be sold by a registered person in the course or furtherance of a taxable activity. This will occur if the sales are on a sufficient scale as to be continuous and regular, and do not form part of the winding down or cessation of the exempt activity. When a registered person ("the vendor") sells a residential rental property in the course or furtherance of a taxable activity, GST is chargeable on the sale of the property unless section 14(1)(d) applies to exempt the sale from GST.

8. Public ruling BR Pub 97/12 was published as "Sale of long-term residential properties—GST implications" *Tax Information Bulletin* Vol 9, No 13 (December 1997). That ruling applied up to 31 March 2001. It is not intended to reissue the ruling as it is considered that an interpretation statement setting out general principles relating to the interpretation of section 14(1)(d) is more useful.

9. This interpretation statement concerns the following aspects of the interpretation of section 14(1)(d).

   - The requirement that the sale be made in the course or furtherance of a taxable activity.

   - What constitutes exclusive use for residential rental purposes.

Legislation

10. Section 8(1) provides:

> Subject to this Act, a tax, to be known as goods and services tax, shall be charged in accordance with the provisions of this Act at the rate of 12.5 percent on the supply (but not including an exempt supply) in New Zealand of goods and services, on or after the 1st day of October 1986, by a registered person in the course or furtherance of a taxable activity carried on by that person, by reference to the value of that supply.

11. Sections 6(1), 6(2) and 6(3)(d) provide:

> (1) For the purposes of this Act, the term **taxable activity** means—
>
> (a) Any activity which is carried on continuously or regularly by any person, whether or not for a pecuniary profit, and involves or is intended to involve, in whole or in part, the supply of goods and services to any other person for a consideration; and includes any such activity carried on in the form of a business, trade, manufacture, profession, vocation, association, or club:
>
> (b) Without limiting the generality of paragraph (a) of this subsection, the activities of any public authority or any local authority.
>
> (2) Anything done in connection with the beginning or ending, including a premature ending, of a taxable activity is treated as being carried out in the course or furtherance of the taxable activity.
>
> (3) Notwithstanding anything in subsections (1) and (2) of this section, for the purposes of this Act the term "taxable activity" shall not include, in relation to any person,—
>
> ….
>
> (d) Any activity to the extent to which the activity involves the making of exempt supplies.

12. Sections 14(1)(c), (ca) and (d) provide:

> The following supplies of goods and services shall be exempt from tax:
>
> …
>
> (c) The supply of accommodation in any dwelling by way of—
>
> (i) Hire; or
> (ii) A service occupancy agreement; or
> (iii) A licence to occupy:
>
> (ca) The supply of leasehold land by way of rental (not being a grant or sale of the lease of that land) to the extent that that land is used for the principal purpose of accommodation in a dwelling erected on that land:
>
> …
>
> (d) The supply, being a sale, by any registered person in the course or furtherance of any taxable activity of—
>
> (i) Any dwelling; or
> (ii) The reversionary interest in the fee simple estate of any leasehold land,—
>
> that has been used by the registered person for a period of 5 years or more before the date of the supply exclusively for the making of any supply or supplies referred to in paragraph (c) or paragraph (ca) of this section:

Analysis

13. For section 14(1)(d) to apply the following criteria must be satisfied.

- The supply must be by way of sale.

- The supply must be by a registered person in the course or furtherance of any taxable activity.

- The property must have been used for the purpose of supplying residential accommodation by way of hire, service occupancy agreement or licence.

- The property must have been used exclusively for that purpose.

- The vendor must have used the property for that purpose for a period of not less than five years up to the date of sale.

"Supply in the course or furtherance of a taxable activity"

14. Section 14(1)(d) exempts from GST supplies that would otherwise be subject to GST. GST is chargeable on the supply of goods or services (other than an exempt supply) by a registered person in the course or furtherance of a taxable activity carried on by that person: section 8(1). An "exempt supply" is a supply that is exempt from tax pursuant to section 14: section 2(1). A taxable activity is an activity that is "carried on continuously or regularly" and involves, or is intended to involve, the supply of goods or services for a consideration: section 6(1). However, "any activity to the extent to which it involves the making of exempt supplies" is not a taxable activity: section 6(3)(d).

15. In *CIR v Databank Systems Ltd* (1989) 11 NZTC 6,093 Richardson J suggested that one of the reasons for the express exclusion of exempt supplies in section 8(1) may have been to make it clear that a supply to which section 14 applied would not be subject to GST, even if it was made in the course or furtherance of a taxable activity.

16. To the extent that an activity involves the making of exempt supplies, it is not a taxable activity: *see Databank* p. 6,103). Therefore, if the sale of a property were made as part of an activity involving the making of exempt supplies, it would not be made in the course or furtherance of a taxable activity.

17. These principles are illustrated by *Case S36* (1995) 17 NZTC 7,237. The taxpayers in *Case S36* had purchased several residential properties for leasing as rental properties as part of their retirement plan, but were forced to sell the properties due to financial difficulties. The Taxation Review Authority ("TRA") found on the facts that the property sales were made in order to wind up an exempt activity and that, therefore, the sales were not made in the course or furtherance of a taxable activity. The TRA accepted that the sale of 20 properties over a two-and-a-half-year period was a continuous or regular activity, but considered the sales were excluded from the scope of the definition of "taxable activity" by section 6(3)(d). The sales were part of the exempt activity of the supply of residential rental accommodation being the winding down or cessation of that activity. The TRA did not accept that the sales constituted a separate activity of property development or dealing.

18. The assumption on which section 14(1)(d) is based is that the sale of rental properties by a residential landlord could constitute a taxable activity if the sales were on a sufficient scale. Section 14(1)(d) was enacted to make it clear that the sale of properties used for residential rental purposes by the Housing Corporation (now Housing New Zealand Ltd), which may regularly sell rental properties to its tenants (or otherwise), would be exempt from GST. This achieves symmetry of treatment, as input tax credits would not have been allowed in respect of the acquisition of such properties. There could also be other "large-scale" residential landlords to whom section 14(1)(d) potentially applies.

19. Therefore, a sale of a residential property is not chargeable with GST if either of the following circumstances applied:

- Although the sale is in the course or furtherance of a taxable activity, the sale is an exempt supply under section 14(1)(d) because the property has been used by the supplier exclusively for the purpose of residential rental for not less than five years.

- The sale is not made by a registered person in the course or furtherance of a taxable activity (for example, the sale is in the course or furtherance of an activity involving the making of exempt supplies). (In those circumstances, it is not necessary to consider whether section 14(1)(d) applies.)

20. Section 14(1)(d) refers to a supply by a registered person in the course or furtherance of a taxable activity, but goes on to provide for a situation where the supply will be treated as exempt (that is, the sale of a property that has been used exclusively for the supply of residential accommodation by way of hire for not less than five years before the date of the sale). Therefore, it is necessary to consider whether section 14(1)(d) applies only if the supplier is a registered person who carries on a taxable activity and the supply is made in the course or furtherance of that taxable activity.

21. Whether section 14(1)(d) applies to the sale of a property made by a registered person in the course or furtherance of a taxable activity, depends on whether the property is a dwelling that has been used exclusively for the purpose of the supply of residential accommodation by way of hire for the required five-year period.

Meaning of "used … exclusively"

22. "Use" has a wide meaning. Its primary meanings are:

- To employ or make use of for a particular aim or purpose;
- To use up or consume.

See *Thornton Estates Ltd v CIR* (1998) 18 NZTC 13,577 (CA).

23. In *Thornton* the taxpayer argued that "used" in the context of section 104A meant "employed, applied, committed or dedicated"; therefore, land held by a property developer at balance date had been used in the production of assessable income as the land had been employed in, and dedicated to, a subdivision development during the income year in which the land was acquired. This argument was rejected. The Court of Appeal considered that in the context of section 104A "not used" meant "not used up". The court noted that the statutory definition of "unexpired portion" referred to that which is left and considered that this interpretation was confirmed by the purpose of section 104A (to achieve a closer matching between the timing of deductions and the recognition of income for income tax purposes).

24. The Commissioner considers that in the context of section 14(1)(d) "used" means "employed for a particular purpose"—in this case, residential rental purposes. The issue in respect of section 14(1)(d) is how a property has been used during the period of five years up to the date of sale, rather than whether the property had been used at a particular point in time (as under section 104A).

25. A property may be used (employed) in a variety of ways. In *Sloss v Sloss* [1989] 3 NZLR 31, 36Richardson J said:

> The physical occupation of property is clearly a use of that property. In its ordinary meaning, "uses" is not, however, confined in that way. In its natural meaning it is a word of wide import. The *Shorter Oxford English Dictionary* gives as the first meaning, "[the] act of using or fact of being used", and amongst the more detailed definitions is, "utilisation or employment for or with some aim or purpose". The owner of land may be said to use the land when, without doing anything on that land, he obtains advantages from the land (*Newcastle CC v Royal Newcastle Hospital* [1959] AC 248, 255), and in *R v Heyworth* (1866) 14 LT 600, 601, Lush J observed that: "The owner 'uses' the place [a slaughter house] by letting it out". Even the giving away of property may be a "use" of that property (*R v Wampole* (Henry K) & Co [1931] 3 DLR 754).

26. Therefore, the following is the case.

- A property may be said to be "used" by the owner when it is physically occupied by the owner.
- A property would also be used when it is rented out by the owner.
- A property could be said to be used by the owner when the owner obtains some advantage from the property without doing anything to it. In *Sloss* Casey J observed that:

> "Use" can attract many shades of meaning in the various contexts in which it appears, but one of its primary definitions in the *Shorter Oxford English Dictionary* relevant to the present inquiry is "employment for or with some aim or purpose". The degree of involvement by the user must vary according to the nature of the particular object. In an ordinary domestic situation, the ability of both spouses to exercise direct physical advantage or control will usually establish whether it is for their common use and benefit,—eg a holiday cottage or the family car. **But other assets may not be capable of**

such a physical relationship, and this is the case with the commercial property here. Its functions were to generate income and serve (hopefully) as an appreciating asset …. Those functions make up its "use" to its owner. (p. 44)[Emphasis added]

In *Newcastle City Council v Royal Newcastle Hospital* [1959] 1 All ER 734 (PC) Lord Denning said:

> Counsel for the city council submitted that an owner of land could not be said to use the land by leaving it unused; and that was all that had been done here. Their Lordships cannot accept this view. An owner can use land by keeping it in its virgin state for his own special purposes. An owner of a powder magazine or a rifle range uses the land he has acquired nearby for the purpose of ensuring safety even though he never sets foot on it. The owner of an island uses it for the purposes of a bird sanctuary even though he does nothing on it, except prevent people building there or disturbing the birds. In the same way this hospital gets, and purposely gets, fresh air, peace and quiet, which are no mean advantages to it and its patients. (p. 735)

A property could be used simultaneously in more than one of the ways outlined above.

27. The definition of "exclusive" in the *Concise Oxford Dictionary* reads as follows.

> 1 excluding other things
> 2 … excluding all but what is specified

28. Therefore, for section 14(1)(d) to apply, the property must have been used for residential rental purposes and for no other purpose for the required period.

What constitutes exclusive use for residential rental purposes?

29. A property that has been rented out for residential rental purposes has clearly been used for that purpose. However, the property could at the same time be used for the purpose of property development (in the sense that an advantage is obtained for the purpose of the property development activity by having the property available for sale as part of the property development activity at that time or in the future). This view is supported by *CIR v Lundy* (2005) 22 NZTC 19,637 (HC); (2005) 22 NZTC 19,637 (CA), which concerned property developers who had acquired properties for sale and had rented out the properties for residential purposes pending sale. The High Court had held that the principal purpose did not change while the properties were rented. It was accepted that the properties had been applied for a non-taxable purpose, and that, therefore, an adjustment under section 21(1) was required. In discussing whether periodic or one-off adjustments were required, the Court of Appeal made the following comments:

> [41] Periodic adjustments, on the other hand, may be suitable where the use for non-taxable purposes is variable or where it is temporary and coincides with continued use in a taxable activity. In the latter case, one-off adjustments may be difficult to calculate and unfairly large where assets are of any size. **In this case, the taxpayers' principal purpose of the sale of the properties in the course of their taxable activities subsisted. The properties were therefore at all times being used for that taxable purpose. They were part of the taxpayers' trading stock and,**

> **indeed, remained on the market at all times. At the same time, they were let for residential purposes, but on a temporary basis.** Periodic adjustments were therefore appropriate. [Emphasis added]

30. In considering the amount of the adjustments required under section 21, the court said:

> [43] The above exercise spreads only the cost of the land and buildings between periods, however. **There still needs to be an apportionment between taxable and non-taxable uses in the particular period. This creates conceptual difficulties because it is not possible to separate out the use of the properties on any time or space basis. In terms of both time and space the properties in this case are 100% dedicated to use for both purposes—see the discussion at [41] above.** There must be an apportionment, however. Apportioning the depreciation on the buildings (but not the land) would be a possible (if somewhat rough and ready) means of recognising both uses**.** This is what the taxpayers did in this case. This was a reasonable allocation method and thus within the scope of the legislation. [Emphasis added]

31. Section 14(1)(d) contains the word "used", while section 21(1) refers to goods or services that a person applies for a purpose other than that of making taxable supplies. The "term "applied" has a wider meaning than "used": *Case N2* (1991) 13 NZTC 3,187. For a property to be "applied" for a particular purpose, it is not necessary that the property be "used" for that purpose, although some overt act on the part of the taxpayer would be required to demonstrate that the property had been so applied. "Applied" has the flavour of allocation for a particular use. The *Concise Oxford Dictionary* definition of "apply" includes "to devote". In this context it is not necessary to draw a distinction between "applied" in section 21(1) and "used" in section 14(1)(1)(d). The use of a property for a particular purpose would normally indicate that the property had been applied for that purpose. If a property has been applied for residential rental purposes, it is also used for residential rental purposes.

32. In *Lundy* the principal purpose in respect of the properties continued to be property development. The properties were part of the taxpayer's trading stock and were on the market at all times. The Court of Appeal considered that the properties were both used and applied for taxable and non-taxable purposes. Although the court in *Lundy* did not directly consider the meaning of "use", the discussion in *Lundy* makes it clear that the court considered the properties were used for taxable purposes as the principal purpose of sale in the course of the taxpayer's taxable activities subsisted (paragraph 41). At the same time the properties were used 100 percent on a time and space basis for residential rental purposes.

33. *Lundy* supports the view that when the principal purpose in respect of a property remains unchanged and the principal purpose in respect of the property continues to be the ultimate sale of the property, the property continues to be used for that activity. That being the case, the property would not be used exclusively for residential rental purposes. This would be so although the property was used 100 percent on a time and space basis for residential rental purposes. These uses are not incompatible. The

Commissioner notes that rather than excluding the use of a property for a property development activity, the rental of the property pending sale could actually facilitate and promote the use of the property for the property development activity (by reducing holding costs or by enhancing sale prospects): *Case S81* (1996) 17 NZTC 7,505; *CIR v Lundy* (2004) 21 NZTC 18,595 (HC).

34. Therefore, section 14(1)(d) will not apply to the sale of a property acquired for the principal purpose of a taxable activity of property development, where the principal purpose in respect of the property remains unchanged and the principal purpose continues to be the ultimate sale of the property. In those circumstances, the property would be used for the property development activity, although on a time and space basis 100 percent of the property may also have been used for the purpose of rental for residential accommodation.

35. This interpretation is consistent with the policy objective underlying section 14(1)(d), which is to ensure symmetry of treatment of properties acquired for the principal purpose of providing residential rental accommodation. An input tax credit would not be available on the purchase of such properties. The effect of section 14(1)(d) is that the sale of the properties is not subject to GST in circumstances where the sale of the properties would otherwise be regarded as a taxable supply (being a supply made by a registered person in the course or furtherance of a taxable activity). Section 14(1)(d) was not intended to exempt the sale of a property in respect of which the vendor had obtained an input tax credit.

36. The *vendor* must have used the property for residential rental purposes for not less than five years up to the date of the sale. It would not be sufficient that the property has been rented out for residential accommodation for a minimum of five years by different owners. However, section 14(1)(d) does not require that the property be occupied by the same tenant throughout the five-year period. Section 14(1)(d) refers to the use of the property by the person selling the property.

37. Section 14(1)(d)(i) could apply even if the property were vacant for periods during the five years while attempts are made to obtain a tenant for the property. In *Schwerzerhof v Wilkins* [1898] 1 QB 640 it was held that premises were used as a bakehouse, although actually vacant, during a period when the owner continued to make attempts to let out the property. That case concerned a provision that permitted an underground place to be used as a bakehouse if it was so used at the commencement of the relevant Act. The premises in question had long been used as a bakehouse, but were vacant at the commencement of the Act. The premises were vacant for a period of five months, during which time the premises were repaired. While the repair work was in progress the owner advertised the premises for lease. The new tenant began to use the premises as a bakehouse immediately and continued to do so. The court considered that the premises were used as a bakehouse at the commencement of the Act. Therefore, if the vendor has continued to be actively engaged in attempting to rent out a property for residential purposes,

the property will continue to be used for residential rental purposes for the purposes of section 14(1)(d).