

QUESTION WE'VE BEEN ASKED QB 15/13

INCOME TAX – WHETHER THE COST OF ACQUIRING AN OPTION TO ACQUIRE REVENUE ACCOUNT LAND IS DEDUCTIBLE

All legislative references are to the Income Tax Act 2007 unless otherwise stated.

This Question We've Been Asked is about s DB 23 and the financial arrangements rules (the FA rules).

Question

1. Where revenue account land is acquired through the exercise of an option, is the cost of acquiring the option deductible?

Answer

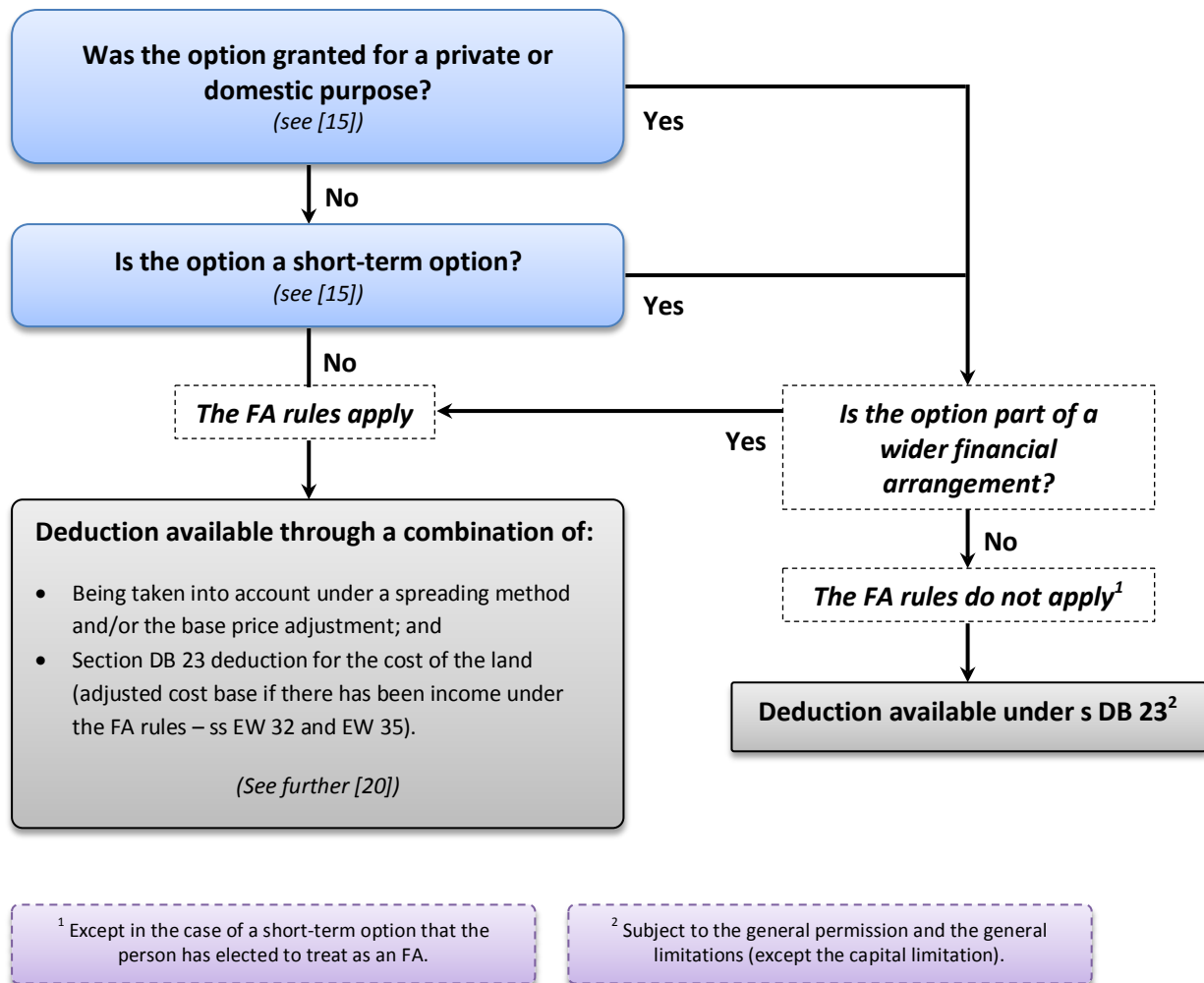
2. Yes, the cost of acquiring the option is deductible as follows:
 - If the FA rules apply to the option (and consequent agreement for sale and purchase of the land), the cost of the option and the other consideration for the land are in effect deductible. Those costs will be taken into account under the FA rules, and the FA rules will then establish the cost base of the land, which will be deductible under s DB 23 on the ultimate sale of the land.
 - Where the FA rules do not apply, the cost of acquiring the option is deductible under s DB 23 because it is part of the cost of acquiring the revenue account land (together with the other consideration for the land).

[Note: throughout this QWBA, references to deductibility under s DB 6 or s DB 23 are subject to the general permission being satisfied, and no general limitation (excluding the capital limitation) applying.]

3. The FA rules will apply unless the option is a short-term option to acquire land, or was granted to the person for a private or domestic purpose.¹ However, the FA rules will apply in those situations if the option is part of a wider financial arrangement. See further from [14] on deductibility where the FA rules apply.
4. If the FA rules do not apply, the only question is whether the cost of the option is part of the cost of the revenue account land. The Commissioner considers that it is, as it is part of what is outlaid in order to acquire the underlying land. See further from [21] on deductibility under s DB 23.
5. If the FA rules apply, the deduction of the cost of the revenue account land may be partly taken through the operation of those rules, and partly taken under s DB 23. The deduction under s DB 23 would be allocated to the income year in which the person disposes of the property.
6. This QWBA also considers the deductibility of the cost of an option that is itself on revenue account – see further from [39].
7. The following flowchart shows how the cost of revenue account land acquired through the exercise of an option is deductible:

¹ Where certain criteria are met – see [15].

How is the cost of revenue account land acquired through the exercise of an option deductible?



Explanation

Background

8. The question we have been asked is whether the cost of acquiring an option to acquire revenue account land is deductible.
9. The question has arisen in the context of the enactment of s CB 15B, which concerns the timing of acquisition of land for the purposes of subpart CB of the Act.² The question is not about the application of s CB 15B as such. However, it has been suggested that s CB 15B requires the separate consideration of different estates or interests in, or options to acquire estates or interests in, the same underlying physical land. As a consequence, it has been suggested that the cost of acquiring an option (which is itself "land" for the purposes of the Act) will only be deductible if the option is revenue account property.

² It is noted that as at the time of publication, there is a proposal for the introduction of a new legislative provision in subpart CB, for which there may be a different time of acquisition rule.

Revenue account property

10. Section YA 1 defines “revenue account property” (relevantly) as:

YA 1 Definitions

In this Act, unless the context requires otherwise,—

...

revenue account property, for a person, means property that—

- (a) is trading stock of the person;
- (b) **if disposed of for valuable consideration, would produce income for the person** other than income under section EE 48 (Effect of disposal or event), FA 5 (Assets acquired or disposed of after deductions of payments under lease), or FA 9 (Treatment when lease ends: lessee acquiring asset):

...

[Emphasis added]

11. There are a number of provisions in subpart CB of the Act which include as income amounts derived by a person from disposing of land. For example, an amount will be income if derived from disposing of land:

- that was acquired with an intention or purpose of disposing of it (s CB 6);
- that was acquired by a person (or someone associated with them) for the purpose of a business of dealing in land, developing land, dividing land into lots, or erecting buildings³ (s CB 7); or
- within 10 years of its acquisition, if at the time of acquisition the person was (or was associated with someone who was) in the business of dealing in land, or developing or dividing land (ss CB 9 and CB 10); or
- within 10 years of the completion of improvements to the land, if at the time the land was acquired the person was (or was associated with someone who was) in the business of erecting buildings (s CB 11); or
- that was part of an undertaking or scheme, meeting certain criteria, that involved the development of land or the division of land into lots (ss CB 12 and CB 13).

Land can therefore be held as “revenue account property”.

Deduction for the cost of revenue account property

12. Section DB 23 allows a deduction for expenditure incurred as the cost of revenue account property. However, if the FA rules apply, they will determine what the cost of the property is regarded as being for the purposes of s DB 23 (see ss EW 2(2)(d) and EW 35).
13. An option (and any consequent agreement for sale and purchase of the land) may be a “financial arrangement” to which the FA rules apply. If it is, the application of the FA rules, which calculate and spread income and expenditure over the term of the financial arrangement, may give rise to income or expenditure. As noted above, the FA rules will then determine what the cost of the property is regarded as being for the purposes of s DB 23 (see ss EW 2(2)(d) and EW 35).

³ If the business is of erecting buildings, the provision also requires that the person, or the associated person, has made improvements to the land – either before or after acquiring it.

Do the financial arrangements rules apply?

14. The FA rules override any other provision relating to the timing or quantification of income or expenditure under a financial arrangement, unless the other provision expressly or by necessary implication requires otherwise (s EW 2). An option to acquire land, and any consequent agreement for sale and purchase of the land, will be a financial arrangement unless it is an excepted financial arrangement (see ss EW 3 and EW 4(3), and the definition of "specified option" in s YA 1). Therefore, in considering the deductibility of the cost of acquiring an option to acquire land, it is necessary to first consider whether the FA rules apply, and what their effect is.
15. As noted above, an option to acquire land, and any consequent agreement for sale and purchase of the land, may be a "financial arrangement" to which the FA rules apply. However, the option and agreement for sale and purchase (a "specified option", as noted above) will **not be** a financial arrangement if it is either:
- **granted to the person, for a private or domestic purpose**, where:
 - the purchase price for the land is less than \$1m; and
 - the option requires settlement of the property, if an agreement is entered into as a result of the exercise of the option, to take place on or before the 365th day after the date on which the option is granted.
- OR
- **A short-term option** – which is:
 - an option under which settlement must take place on or before the 93rd day after the date on which the option is entered into; or
 - if that date cannot be established, an option under which settlement must take place before the 93rd day after the earlier of the date on which the buyer first makes a payment to the seller and the date on which the first right in the property is transferred,

(though such an option will be a financial arrangement for a party who makes an election under s EW 8 to treat it as one).
16. In either of the above situations, the "specified option" will be an excepted financial arrangement. However, an excepted financial arrangement may be part of a wider financial arrangement. Generally, amounts that are solely attributable to excepted financial arrangements are not taken into account under the FA rules. However, in either of the above situations, if the specified option is part of a wider financial arrangement, any amount solely attributable to the excepted financial arrangement will need to be taken into account under the FA rules (s EW 6(3)).
17. Therefore, if an option (and any consequent agreement for sale and purchase of the land) falls into one of the above two categories, the deductibility of the cost of the option (together with the other consideration for the land) will fall for consideration under s DB 23, unless the specified option is part of a wider financial arrangement, in which case the FA rules would need to be considered first.
18. Any other option to acquire land, and any consequent agreement for sale and purchase of the land, will be a financial arrangement (a "specified option") to which the FA rules apply.

What is the effect of the financial arrangements rules applying?

19. A "cash basis person" is not required to apply any of the spreading methods under the FA rules to their financial arrangements, but may choose to do so under s EW 61 (ss EW 13(3) and EW 55(1)). A person will be a cash basis person for an income year if the value of financial arrangements to which they are a party does not exceed the prescribed thresholds in s EW 57(1)–(3) (s EW 54).
20. Where the FA rules apply, the deductibility of the cost of acquiring an option to acquire land (together with the other consideration for the land) is determined as follows:
 - Income or expenditure under the financial arrangement is calculated and allocated to each income year of the financial arrangement's term under the appropriate spreading method (if spreading is required) and base price adjustment in the year that is required.
 - Any expenditure under the financial arrangement is interest (as defined in s YA 1), and may be deductible under s DB 6 or s DB 7.
 - Any income under the financial arrangement is income under s CC 3 and would need to be returned in the year(s) to which it is allocated under the FA rules.
 - Presuming there is no wider financial arrangement, the base price adjustment would typically be required in either the year the option expires or is disposed of, or in the year that any consequent agreement for sale and purchase of the land is settled.⁴
 - The cost of the option, and the other consideration paid for the land (if the option was exercised) would be taken into account in calculating the amount of income (if any) under the FA rules.
 - Where the option is exercised and the land acquired, the purchaser is paid consideration that includes property. The value of the property for the purposes of the FA rules is determined under s EW 32. This value may be more or less than what the option holder paid for it. As such, the purchaser may have income or expenditure under the FA rules.
 - If the land the subject of the option was acquired and is revenue account property, when the person disposes of that land the amount derived on the disposal will be income. A deduction for the cost of the land will be allowed against the sale proceeds, under s DB 23.⁵ Section EW 35 provides that for the purposes of determining the amount of that deduction, the person will be treated as acquiring the land for the value determined under s EW 32. What this means in effect is that if the purchaser has already returned some income under the FA rules because the value of the property under s EW 32 was more than what was paid for it, that higher value is the cost base for the property. Similarly, if the purchaser has already had expenditure under the FA rules because the value of the property under s EW 32 was less than what was paid for it, that lower value is the cost base for the property.

⁴ The base price adjustment could be required at a different time – see s EW 29.

⁵ As noted above, this is subject to the general permission being satisfied, and no general limitation (excluding the capital limitation) applying.

Cost of revenue account property

21. Whether or not the FA rules apply, the deductibility of the cost of revenue account land acquired by way of an option will be determined by s DB 23. It just may be that the FA rules determine what the “cost” of the land is considered to be.
22. Section DB 23 provides for the deductibility of expenditure incurred as the cost of revenue account property, stating:

DB 23 Cost of revenue account property

Deduction

- (1) **A person is allowed a deduction for expenditure that they incur as the cost of revenue account property.**

No deduction

- (2) Despite subsection (1), a person is denied a deduction for expenditure incurred as the cost of revenue account property if—
 - (a) [Repealed]
 - (b) section CX 55, CX 56B, or CX 56C (which relate to portfolio investment income) applies to income derived by the person from the disposal of the revenue account property.

Relationship with sections CU 2 and DU 3

- (2B) Sections CU 2 (Treatment of mining land) and DU 3 (Acquisition of land for mining operations) override this section in relation to land or an interest in land as described in section CU 2(1)(b) that a mineral miner acquires for the purposes of their mining operations or associated mining operations.

Link with subpart DA

- (3) Subsection (1) overrides the capital limitation but the general permission must still be satisfied. Subsection (2) overrides the general permission. The other general limitations still apply.

[Emphasis added]

23. If a deduction is allowed under s DB 23, it is allocated to the earlier of the income year in which the person disposes of the property or the income year in which the property ceases to exist (s EA 2(2)).
24. Where land is revenue account property for a person, the cost of acquiring the land⁶ would obviously be expenditure incurred as the cost of acquiring revenue account property. The question we have been asked is whether the cost of acquiring an option, which is then exercised in order for the land to be acquired, will also form part of the cost of acquiring the land, and therefore be deductible.

Meaning of “cost”

25. The Act does not define “cost” for the purposes of s DB 23, however, numerous cases have considered its meaning, for example *Tasman Forestry Limited v CIR* (1999) 19 NZTC 15,147 (CA) and *CIR v Atlas Copco (NZ) Ltd* (1990) 12 NZTC 7,327, which are discussed below.
26. *Tasman Forestry* involved consideration of what the cost of certain forestry assets acquired by the taxpayer was, as the taxpayer was allowed a deduction for this cost against profits or gains derived from the sale of timber.
27. Following a merger, it was decided that Tasman Forestry Limited (Tasman) would hold the forestry holdings of approximately 20 forestry companies in the group. Tasman acquired the shares of those companies at fair market value. Each of those companies was then wound up, and the forestry assets of the company

⁶ Excluding any interest element under the FA rules – though there is unlikely to be any.

were distributed to Tasman (referred to as an *in specie* distribution). In addition, Tasman entered into an agreement with another company, under which forestry assets were exchanged.

28. As noted above, the issue in *Tasman Forestry* was what the cost of the forestry assets Tasman acquired was.
29. The Court of Appeal discussed the meaning of "cost", and adopted the *Shorter Oxford English Dictionary* definition, being "that which must be given in order to acquire something". The court also stated that "cost" has a wider meaning than payment on purchase, and the fact that determination of cost may require a valuation exercise does not mean there is no cost.
30. In terms of the mechanism through which the forestry assets were acquired, the court noted at 15,157:

[37] We consider the correct course is not to dissect the transactions by which the forests were acquired, but to view them in their commercial reality. As the Judge found, the shares were purchased as the means for, and with the intention of, acquiring the forests. For practical purposes the cost to Tasman in acquiring the forests was the amount paid for the company shares which gave access to the forest assets. The appropriate proportion of that cost is to be treated as the cost of the timber.

[38] This accords with the approach that would be taken in respect of other personal property in applying the third limb of s 65(2)(e) relating to profit making schemes. It also accords with the approach taken by *Mason J* at first instance and *Gibbs J* in the Full Court of the High Court of Australia in *Steinberg v Federal Commissioner of Taxes*. *Gibbs J* said (697):

In the circumstances of the present case, where the shares were bought to enable the land to be acquired, the cost of the shares and of the winding up of the company and distribution of the assets can rightly be regarded as the amount actually outlaid for the purpose of, and in the process of, acquiring the land, although the acquisition was effected not directly, but by a number of steps. In my opinion, therefore, *Mason J* was right for the reasons which he gave.

[39] *Barwick CJ*, dissenting, held there was no profit-making scheme. Accordingly he did not consider the present point and his earlier analysis (683) was directed to the other limb of the Australian provision, the counterpart of the second limb of s 65(2)(e), concerned with the narrower issue of the calculation of profits on sale of property, acquired for the purpose of sale at a profit.

[40] In each case involving acquisition by Tasman on distribution in specie there was no question that the purchase of the company shares was made for the purpose of acquiring the forests. Accordingly the cost of timber for Tasman was that proportion of the price paid for the shares allocated to the standing timber. Only in the case of the Matahina forest does the cost differ from that for which Tasman contended. In that case the subsequent revaluation of the forest by *Crista* cannot be taken into account in the cost of timber for Tasman.

31. The right to receive a distribution of the forestry assets on the winding up of the companies flowed from Tasman's ownership of the shares in those companies. Therefore, the court considered that the cost of the forestry assets to Tasman was the amount paid for those shares.
32. The meaning of "cost" was also considered in *Atlas Copco*. The issue in that case was what the value of fringe benefits provided by the taxpayer to its employees was. The legislation provided that the value of the benefits was to be determined based on the "cost" of the benefits to the taxpayer. The taxpayer argued that this cost did not include the GST component of the relevant expenditure, because ultimately the taxpayer was able to recover that component by claiming input tax deductions. The Commissioner argued that the taxpayer being able to claim back the GST component did not change the fact that the GST component was part of the cost incurred.
33. The High Court found for the taxpayer, and considered that the approach suggested by the Commissioner was unduly restrictive and would not give effect to the realities of the situation, noting at 738:

I have reached the conclusion that the approach suggested by the Commissioner is unduly restrictive and does not give effect to the realities of the situation. The Commissioner contends that the Court should focus only upon one element of the statutory scheme - the payment of the purchase price - and should turn a blind eye to other integral steps in the scheme such as the subsequent deduction of input tax by the registered purchaser. In reality, and in law, there are three components of a sale transaction between a registered vendor and a registered purchaser; the vendor's obligation to pay output tax, the purchaser's payment of the purchase price and the purchaser's subsequent deduction of input tax. The deduction of input tax is not analogous to "a later transaction with a third party" as contended by the Commissioner in the example cited - it is a fundamental part of the whole transaction, and is necessary to give effect to the statutory intention that GST be a tax upon the end-user.

34. The court also had regard to the evidence given by two accountants as to the commonly held commercial understanding of the word "cost". The court observed that where the meaning of words in a statutory context is unclear or ambiguous, the court may derive some assistance from common business parlance and practice, as well as international standards. The accountants were in agreement about the normal accounting usage of the term "cost". One of the accountants had stated that there is "an internationally recognised concept of cost which has been applied in a number of jurisdictions and which has been given a consistent meaning over the years in each of them". He then went on to say that "the general principle is that cost is the economic sacrifice incurred in economic activities – that which is given up or forgone to consume, to save, to exchange, to produce and so forth".
35. *Tasman Forestry, Atlas Copco* and other authorities have established that:
- The word "cost" is capable of various meanings, depending on the context.
 - "Cost" means that which must be given in order to acquire something, and has a wider meaning than payment on purchase.
 - In determining "cost", a transaction must be viewed in its commercial reality, and some assistance may be derived from common business parlance and practice.
36. Despite this, as noted above, if the FA rules apply, they will determine what the cost of the property is regarded as being for the purposes of s DB 23 (see ss EW 32 and EW 35). The following discussion is premised on the FA rules not applying. If the FA rules apply, see the last bullet point at [20] in relation to the cost base of the property.

Is the cost of acquiring an option to acquire land part of the "cost" of acquiring the land?

37. It is noted that an option to acquire land or an estate or interest in land is itself land for the purposes of the Act (definition of "land" in s YA 1). It has been suggested that s CB 15B (which concerns the timing of acquisition of land for the purposes of subpart CB) requires the separate consideration of different estates or interests in, or options to acquire estates or interests in, the same underlying physical land. As a consequence, it has been suggested that the cost of acquiring an option (which is itself "land" under the Act) will only be deductible if the option is revenue account property. The Commissioner does not agree. Under s CB 15B, an estate or interest in land may be acquired at the time an earlier estate or interest in the land first arose. However, the issue of the timing of acquisition of land is entirely separate from the issue of what the cost of the land is.
38. On the basis of the meanings that the courts have given to the word "cost", the Commissioner considers that where an option is acquired in order to acquire land, the cost of acquiring the option will form part of the cost of acquiring the underlying land. The cost of acquiring the option is part of what is outlaid in order to acquire the land. Where the FA rules do not apply, and the land is

revenue account property of the taxpayer, the cost of acquiring the option will therefore be deductible under s DB 23 against the proceeds derived from the disposal of the underlying land. As noted above, this is subject to the general permission (s DA 1(1)) being satisfied.⁷

39. There may be situations where the option is itself revenue account property (for example, because it was acquired with the intention of being sold), but is not in fact sold (ie, because it is instead exercised or expires). The option would be revenue account property even though it was not sold. As noted at [10], revenue account property for a person includes property that **if** disposed of for valuable consideration, would produce income for the person.⁸ The cost of acquiring the option would clearly be expenditure incurred as the cost of acquiring the revenue account property (the option). However, although s DB 23 overrides the capital limitation, the general permission (s DA 1(1)) must still be satisfied in order for the person to be able to claim a deduction under s DB 23 on the exercise or expiry of the option.
40. The general permission requires there to be a nexus between the expenditure and the derivation of assessable and/or excluded income, or for the expenditure to have been incurred in the course of the person carrying on a business for the purposes of deriving assessable and/or excluded income. In the example noted above, the option was on revenue account because it was acquired with the intention of being sold. As such, the general permission would be satisfied, even though there would not be any income derived on the exercise or expiry of the option (see for example *CIR v Inglis* [1993] 2 NZLR 29 (CA) and *CIR v Stockwell* [1993] 2 NZLR 40 (CA)). The cost of acquiring the option would therefore be able to be deducted in the year in which the option is exercised or expires.
41. If the option is exercised, and the underlying land was also revenue account property, the cost of acquiring the option would be part of what is outlaid in order to acquire the underlying land, even though it was not intended at the time the option was acquired that it would be exercised and the underlying land acquired. However, the cost of acquiring the option would have been deducted in the year the option was exercised. As such, no further deduction for the cost of the option would be allowed on the disposal of the revenue account land that is the subject of the option (s BD 4(5)).
42. A further scenario that has been raised is if someone acquires an option with no intention to dispose of the option, but intending to acquire the land the option relates to. However, instead of acquiring the underlying land as intended, the option was either disposed of or expired without being exercised. In this scenario, the fact that the underlying land may have been revenue account property if acquired is not relevant, as it was not acquired. Unless the option was revenue account property, the cost of its acquisition would not be deductible under s DB 23, as there simply was no revenue account property. If the option was revenue account property, the general permission would need to be satisfied for a deduction to be permitted under s DB 23, as noted above.

⁷ Although s DB 23 overrides the capital limitation, the general permission (s DA 1(1)) must still be satisfied.

⁸ Other than under s EE 48, FA 5 or FA 9.

Examples

43. The following examples are included to assist in explaining when the cost of acquiring an option to acquire land (together with the other consideration for the land, if the option is exercised) will be deductible. They assume that none of the general limitations (excluding the capital limitation, which s DB 23 is not subject to) apply.

Example 1 – Cost of option part of cost of revenue account land

44. Company A, a hotel developer, wished to acquire a piece of land in Taupo to build a hotel on. Company A sought an option to acquire the land, to enable it time to establish whether the necessary consents and planning permissions would be forthcoming. The owner of the land agreed to grant an option, under which Company A had the right to purchase the land for an agreed sum, provided that settlement took place within 3 months of the date the option was granted. Company A paid a \$20,000 option fee for the grant of the option. Once Company A was satisfied that the required consents and permissions would be able to be obtained, it exercised the option and acquired the land. Once the hotel construction was completed, Company A sold the land to a local hotelier. The land was revenue account property of Company A.
45. The option was a “short-term option”, and company A had not made an election under s EW 8, so the option was an excepted financial arrangement. The option was not part of a wider financial arrangement. As such, the FA rules do not apply, and the deductibility of the cost of the option (together with the other consideration for the land) is determined by s DB 23.
46. The option was acquired in order for Company A to acquire the land, which was revenue account property of Company A. The option fee was part of what Company A outlaid in order to acquire the land. As such, the cost of acquiring the option (\$20,000) formed part of the cost of Company A’s acquisition of the land, and would be deductible under s DB 23⁹ (together with the other consideration for the land) in the income year in which Company A disposed of the land (s EA 2(2)).

Example 2 – Deduction for cost of revenue account property when the FA rules apply but there was no income under those rules in respect of the option and ASAP to acquire the property

47. Kylie paid \$10,000 for an option to acquire a house in Nelson for \$1.1m at any time in the six months from the date the option was granted. Kylie was planning to acquire the property, do some minor renovations to it, and sell it at a profit. Five months into the term of the option, once Kylie sold another property she owned, she exercised the option and acquired the property. The sale of the property was settled six weeks later. Kylie undertook the renovations, and sold the property for \$1.5m just over two years later. Kylie is a cash basis person (see [19]) and has not elected to use a spreading method.
48. Kylie did not acquire the option for a private or domestic purpose, and in any event, the purchase price for the property was more than \$1m. The option is not a short-term option (see [15]). The option and agreement for sale and purchase was therefore not an “excepted financial arrangement” but a financial arrangement (a “specified option”) to which the FA rules apply. As such, a base price adjustment was required when the agreement for sale and purchase (under which Kylie acquired the property) was settled.

⁹ The general permission is satisfied because Company A acquired the property intending to sell it.

49. The base price adjustment formula requires Kylie to deduct the amount of consideration paid **by** her under the financial arrangement (the option and consequent agreement for sale and purchase of the land) from the amount of consideration paid **to** her under the financial arrangement. None of the other elements of the base price adjustment formula are relevant in this case.
50. The consideration paid **by** Kylie under the financial arrangement was \$1,110,000 (the cost of acquiring the option, and the purchase price for the land). The consideration paid **to** Kylie under the financial arrangement is the value of the land as determined by applying s EW 32. In this case, that is the lowest price the parties (Kylie and the person she purchased the property from) would have agreed on for the land, on the date the option was granted, if payment had been required in full at the time of settlement under the agreement for sale and purchase. The Commissioner and Kylie agree that the lowest price the parties would have agreed, at the time the option was granted, if payment had been required in full at settlement, is \$1,110,000.
51. The result of Kylie's base price adjustment calculation is therefore \$0 (\$1,110,000 – \$1,110,000 = \$0). That means that Kylie does not have any income or expenditure under the FA rules.
52. The underlying (freehold) land, which Kylie ended up acquiring, was revenue account property for her, as she acquired it with the intention of disposing of it after undertaking some renovations. The amount Kylie derived from selling the land (\$1.5m) is therefore income to Kylie (s CB 6¹⁰), and the cost of acquiring the land is deductible under s DB 23¹¹ against the sale proceeds. For the purposes of determining the amount of that deduction, Kylie is treated as having acquired the land for the value determined under s EW 32 (\$1,110,000) – the same as what she actually paid for the land. This means that Kylie will pay tax on net proceeds of \$390,000 from the sale.

Example 3 – Deduction for cost of revenue account property when there has been earlier income under the FA rules in respect of the option and ASAP to acquire the property

53. Simon incurred \$30,000 to acquire an option from a farmer to purchase a tract of farm land near a large suburban subdivision that was being undertaken. Simon was entitled to exercise the option to purchase the land during a period of three years, for \$2m. Simon did not plan to exercise the option; he had acquired the option in anticipation of the first stage of the subdivision being successful and the subdivision being expanded further, at which time Simon envisaged that he would be able to sell the option to the developer for a profit. By two and a half years later (six months before the option period was over), it had become clear that the development was proceeding more slowly than expected, and the developer was not yet interested in further expansion of the development. Simon felt further expansion was inevitable, but since he could not make any profit selling the option, he decided to exercise it and acquire the land from the farmer, intending to on-sell the land to the developer once it was needed for further subdivision. Simon ended up selling the land to the developer three years later for \$3.5m. Simon is a cash basis person (see [19]) and has not elected to use a spreading method.
54. Simon did not acquire the option for a private or domestic purpose, and it is not a short-term option (see [15]). The option and consequent agreement for sale and purchase of the land was therefore a financial arrangement (a "specified option")

¹⁰ It is assumed for the purposes of this example that there are no applicable exclusions from s CB 6.

¹¹ The general permission is satisfied because Kylie acquired the property intending to sell it.

to which the FA rules apply. As such, a base price adjustment was required when the agreement for sale and purchase was settled.

55. The base price adjustment formula requires Simon to deduct the amount of consideration paid **by** him under the financial arrangement (the option and consequent agreement for sale and purchase of the land) from the amount of consideration paid **to** him under the financial arrangement. None of the other elements of the base price adjustment formula are relevant in this case.
56. The consideration paid **by** Simon under the financial arrangement was \$2,030,000 (the cost of acquiring the option, and the purchase price for the land). The consideration paid **to** Simon under the financial arrangement is the value of the land as determined by applying s EW 32. In this case, that is the lowest price the parties (Simon and the farmer) would have agreed on for the land, on the date the option was granted, if payment had been required in full at the time of settlement under the agreement for sale and purchase. The Commissioner and Simon agree that the lowest price the parties would have agreed, at the time the option was granted, if payment had been required in full at settlement, is \$2,035,000.¹²
57. The result of Simon's base price adjustment calculation is therefore \$5,000 (\$2,035,000 – \$2,030,000 = \$5,000). That \$5,000 is income to Simon under s CC 3 (see s EW 31(3)) in the year the base price adjustment is required (the year the agreement for sale and purchase was settled).
58. The underlying (freehold) land, which Simon ended up acquiring, was revenue account property for him, as he acquired it with the intention of disposing of it. The amount Simon derived from selling the land to the developer (\$3.5m) is therefore income to Simon (s CB 6), and the cost of acquiring the land is deductible under s DB 23 against the sale proceeds. For the purposes of determining the amount of that deduction, Simon is treated as having acquired the land for the value determined under s EW 32 (\$2,035,000), rather than the \$2,030,000 he actually paid for the land. This in effect takes account of the fact that Simon had \$5,000 of income under the FA rules in the year he purchased the land. This means that Simon will pay tax on net proceeds of \$1,465,000 from the sale.

¹² Depending on the commercial drivers in different situations, it may be that the lowest price the parties would have agreed at the time an option is granted, if payment had been required in full at the time of settlement, is **less than** the option fee plus the purchase price under the agreement for sale and purchase. If that is the case, the purchaser would have expenditure under the FA rules, and a corresponding decrease in the cost base of the land. The fact that Simon in this example has income under the FA rules is for illustrative purposes only.

References

Subject references

Income Tax, cost of land that is revenue account property, options

Legislative references

Income Tax Act 2007 – ss CC 3, BD 4(5), CB 15B, DB 6, DB 7, DB 23, EW 2, EW 3, EW 4(3), EW 6(3), EW 8, EW 13(3), EW 32, EW 35, EW 54, EW 55(1), EW 57, ZA 3, the definitions

of “land”, “revenue account property” and “specified option” in s YA 1, and Schedule 51
Income Tax Act 2004 – s EH 26(1A)
Income Tax Act 1994 – s YA 3 and Schedule 22A

Case references

CIR v Atlas Copco (NZ) Ltd (1990) 12 NZTC 7,327
CIR v Inglis [1993] 2 NZLR 29 (CA)
CIR v Stockwell [1993] 2 NZLR 40 (CA)
Tasman Forestry Limited v CIR (1999) 19 NZTC 15,147 (CA)