Inland Revenue
Te Tari Taake

19 December 2018

QUESTION WE'VE BEEN ASKED

QB 18/17

Income tax — bright-line test — farmland and main home exclusions — sale of lifestyle blocks

This Question We've Been Asked (QWBA) explains when lifestyle blocks sold within the bright-line period will be excluded from the bright-line test. It will be of interest to sellers seeking to rely on the farmland or main home exclusions.

Key provisions

Income Tax Act 2007, ss CB6A, CB 16A and YA 1 definitions: "farmland", "residential land"

Question

When is the sale of a lifestyle block sold within the bright-line period excluded from the bright-line test?

Answer

The sale is excluded when the farmland or main home exclusions apply:

1. **The farmland exclusion will apply where the land is, or could in its current state, be used for a farming or agricultural business carried on by the owner. Lifestyle blocks are generally not farmland.**
2. **The main home exclusion will apply where:**
   - **More than 50% of the area of the land has been used for the seller's main home. This includes curtilage and other land used for residential purposes; and**
   - **The land has been used in that manner for more than 50% of the time the seller owned it.**

Key terms

Bright-line period: The bright-line period is 2 years or 5 years, depending on the rules in place when the seller acquired the land.

Bright-line test: The bright-line test applies to tax sales of residential land occurring within the bright-line period.

Curtilage: An area of land attached to a dwelling and forming one enclosure with it, such as a yard or garden.

Main home: A dwelling that is mainly used as a home by the seller and, if the seller has more than one, the home with which the seller has the greatest connection.

Explanation

The bright-line test

1. The bright-line test taxes residential land sold within the bright-line period.

2. The bright-line test applies to residential land that a person first acquired an interest in on or after 1 October 2015. The period of the bright-line test increased from 2 years to 5 years for residential land that a person first acquired an interest in, on or after 29 March 2018 (see s 6(2) of the Taxation (Annual Rates for 2017–18, Employment and Investment Income, and Remedial Matters) Act 2018). Therefore, this QWBA refers to the "bright-line period" which will be 2 years or 5 years, depending on when the seller first acquired an interest in the land.

Scope of this QWBA

3. This QWBA is about when the sale of a lifestyle block is excluded from the bright-line test. It considers the farmland and main home exclusions as these are the most relevant exclusions in this context. The business premises exclusion is not discussed in this QWBA.

4. In this QWBA it is assumed that:

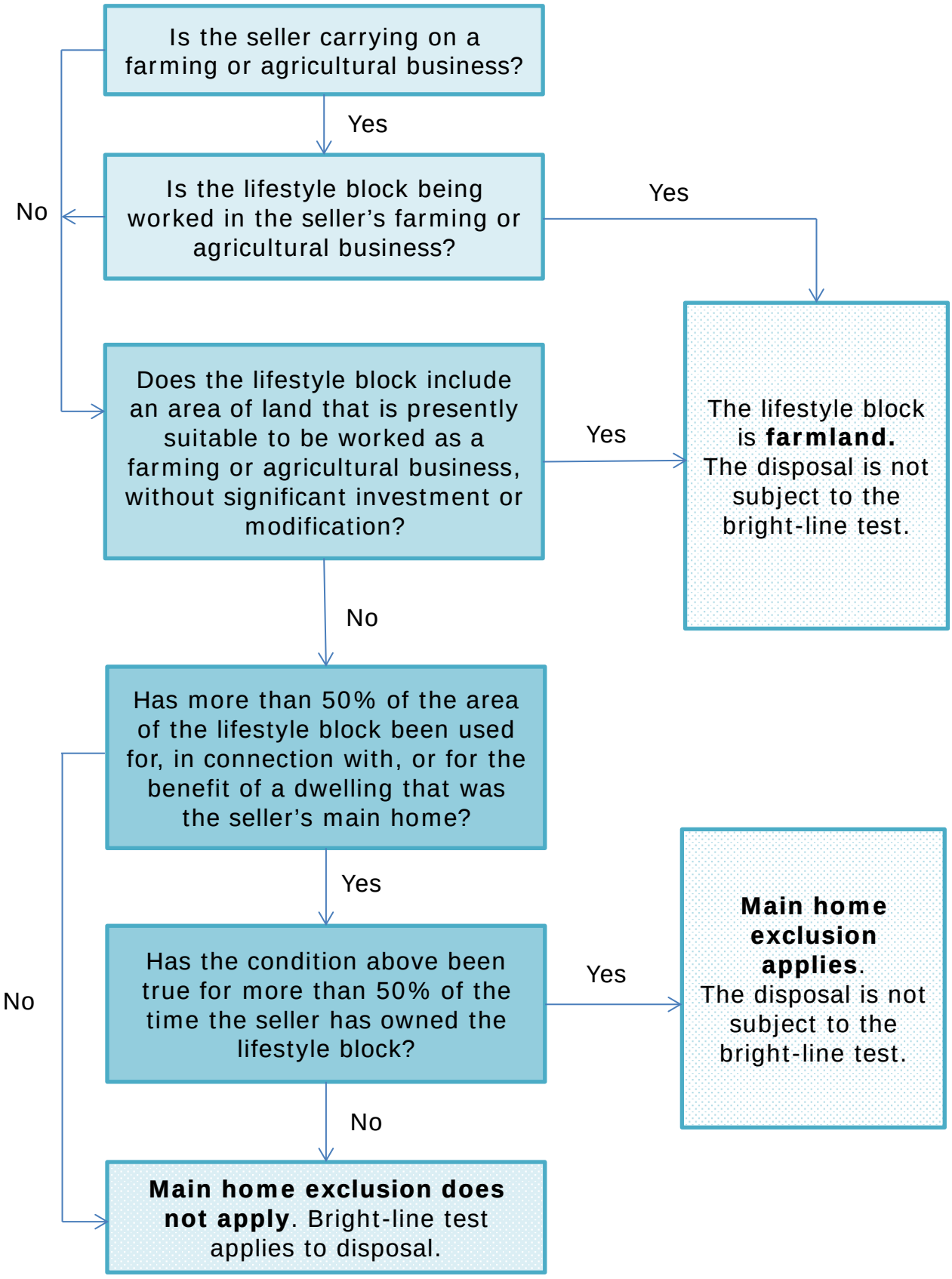
- there was a dwelling on the land that was the seller's main home;
- none of the other land rules in ss CB 6 to CB 12 of the Income Tax Act 2007 apply to the sale of the land (eg, s CB 6, which applies to the sale of land acquired for the purpose of re-sale). The bright-line test potentially applies only where the sale is not taxed under any of the other land rules; and
- none of the exceptions to the main home exclusion apply (see [40]).

5. Additionally, for simplicity this QWBA assumes that the person disposing of the land is not the trustee of a trust. However, the analysis and conclusions in this QWBA are equally applicable if:

- The person disposing of the land is the trustee of a trust, and
- The dwelling was the main home for a beneficiary of the trust; and either
  - A principal settlor of the trust does not have a main home; or
  - The dwelling was the main home of a principal settlor.

6. The flowchart summarises the main steps when determining whether the bright-line test applies to a lifestyle block. These steps address the question of whether the land is farmland and the application of the main home exclusion. The flowchart assumes that the lifestyle block is residential land if it is not farmland, and that none of the exceptions to the main home exclusion apply.

Flowchart: Steps to determine whether the bright-line test and main home exclusion apply to a sale of a lifestyle block within the bright-line period



Is a lifestyle block "farmland"?

7. The bright-line test applies to sales and other disposals of "residential land". The definition of residential land relevantly excludes "farmland". Therefore, if a lifestyle block is "farmland", it is not subject to the bright-line test.

8. "Farmland" is defined. To be "farmland", an area of land needs to be **land** that:

   - is being worked in the farming or agricultural business of the land's owner; or
   - because of its area and nature, is capable of being worked as a farming or agricultural business.

9. The first limb of the "farmland" definition focuses on the actual use of the land, while the second limb focuses on the qualities of the land. The criteria in the definition of farmland are objective. The onus is on the seller to prove the land is farmland and, therefore, that the bright-line test does not apply. Because "residential land" is defined for the bright-line test only, it follows that the time for testing whether land is farmland is when the bright-line test applies; that is, at the time the land is sold.

10. Farmland can include land that has a dwelling on it. In determining if the land is farmland there is no apportionment between the area of land used for the dwelling and the area of land used for farmland. Land is either farmland or not farmland. Therefore, if a lifestyle block is farmland, it is not subject to the bright-line test because it is not residential land.

When is a lifestyle block being worked in the farming or agricultural business of the seller?

11. Under the first limb of the definition, a lifestyle block will be farmland if it is being worked in the farming or agricultural business of the seller. This requires the seller to be able to show that:

    - they are carrying on a farming or agricultural business, and
    - the lifestyle block is being worked in that business.

12. The Commissioner considers that in the context of the bright-line test and the definitions of residential land and farmland, a farming or agricultural activity is being carried on when a lifestyle block is being used for:

    - cultivating and growing crops, including horticulture and viticulture,
    - breeding or rearing livestock, including poultry and bee keeping, or
    - forestry.

13. In addition, the farming or agricultural activity must be carried on as a business.

14. The leading case on the meaning of "business" is *Grieve v CIR* (1984) 6 NZTC 61,682 (CA). *Grieve* concerned a farming activity that, ultimately, did not generate profits. Richardson J interpreted "business" as meaning an activity carried on in an organised and coherent way with an intention to make a profit. A person's intention to make a profit will be evidenced by their conduct. Factors that are relevant for determining if a person is carrying on a business include:

    - the nature of the activity being engaged in;
    - the period over which the activity is engaged in;
    - the scale of operations;
    - the volume of transactions;

- the commitment of time, money and effort;
- the pattern of activity; and
- the financial results.

15. Whether a lifestyle block is being worked in the farming or agricultural business of the seller is a question of fact. Many owners of lifestyle blocks will keep animals or grow crops or trees on their land, but if the livestock or produce of the activity is not sold (or not intended to be sold), then there will be no business activity. Even if the livestock or produce is sold, the owner may not be able to demonstrate that they are carrying on that activity in an organised and coherent way with the intention to profit from the activity, as is required for the activity to be a business. For many lifestyle block properties, the size and nature of the property will limit the scale of operations that can be carried on, which will make it difficult to satisfy the business test.

16. The first limb of the "farmland" definition requires that the land is "being worked in the farming or agricultural business **of the land's owner**". This means the seller of the lifestyle block must be engaged in a farming or agricultural business and the land must be "being worked" in that business. The business requirement can be satisfied if the lifestyle block is being worked, in conjunction with other land that is owned or leased by the seller, in their business. However, this requirement would not be satisfied where the land is merely being rented to someone else who carries on a farming or agricultural business.

When is a lifestyle block, because of its area and nature, capable of being worked as a farming or agricultural business?

17. The second limb of the "farmland" definition includes land that, "because of its area and nature", is capable of being worked as a farming or agricultural business. This requires consideration of both the area and the nature of the land together to determine if the land is capable of being worked as a farming or agricultural business.

18. Whether a lifestyle block is an **area** capable of being worked as a farming or agricultural business depends on the proposed activity the seller considers it capable for. The seller needs to evaluate whether the area of the lifestyle block is sufficient to enable it to be worked as a farming or agricultural business when considering the proposed activity. The larger the area of the lifestyle block, then potentially the larger the scale of any farming or agricultural activity and the greater the likelihood that the proposed activity will constitute a business. It would be difficult for the seller to show a lifestyle block is capable of being worked as a farming or agricultural business if the area of the block means it would not be capable of producing a profit when used for the proposed activity. In establishing whether the land being sold has an area and nature capable of being worked in a farming or agricultural business it needs to be considered in isolation from other parcels of land.

19. The Commissioner considers, based on *CIR v Bruhns* (1989) 11 NZTC 6,075 (CA), that the words "is capable of being" in para (b) focus on the existing or present nature of the lifestyle block at the date of sale, rather than any unrealised potential in the lifestyle block. This means a lifestyle block that requires significant investment or modification to be used in the proposed activity does not have the **nature** to make it capable of being worked as a farming or agricultural business, and the lifestyle block would not qualify as farmland.

20. The onus is on the seller to prove that the lifestyle block at the date of sale has an area and nature presently capable of being worked as a farming or agricultural business and is, therefore, farmland not subject to the bright-line test. In practice, the seller would need to have a particular farming or agricultural business that they argue the lifestyle block is capable of being used for. They would also have to show

that any investment or modification needed to carry on that activity is not significant. This will be a question of fact.

21. There may be situations where the owner of land that is farmland lives in the farm house and leases the majority of the land to someone else to farm. In such cases, all of the land, including the farm house, will be generally regarded as farmland and the sale of the land will not be taxed under the bright-line test.

Is a lifestyle block "residential land"?

22. The definition of residential land includes:

- land that has a dwelling on it;
- land for which the owner has an arrangement that relates to erecting a dwelling; or
- bare land that is allowed to have a dwelling on it under the relevant operative district plan.

23. And, as noted above, the definition of residential land relevantly excludes farmland.

Can the main home exclusion apply to a lifestyle block?

24. The main home exclusion can apply to a lifestyle block. The main home exclusion will apply if the lifestyle block has been used predominantly, for most of the time the seller owns it, for a dwelling that was the seller's main home. The onus is on the seller to prove the main home exclusion applies and, therefore, that the bright-line test does not apply.

25. The main home exclusion in s CB 16A(1) provides:

> **CB 16A Main home exclusion for disposal within 5 years**
>
> *Main home exclusion*
>
> (1) Section CB 6A does not apply to a person who disposes of residential land, if the land has been **used predominantly, for most of the time the person owns the land, for a dwelling that was the main home** for—
>
> (a) the person; or
>
> (b) a beneficiary of a trust, if the person is a trustee of the trust and—
>
> (i) a principal settlor of the trust does not have a main home; or
>
> (ii) if a principal settlor of the trust does have a main home, it is that main home which the person is disposing of.
>
> [Emphasis added]

26. The main home exclusion has a number of elements, which are discussed below.

27. The land in the lifestyle block must have been used predominantly for a dwelling that was the seller's **main home** for more than 50% of the seller's period of ownership. "Main home" is defined in s YA 1.

28. There are three points to note about the "main home" definition:

- A person can only have one "main home" under this definition.
- To be the "main home" of a person, a dwelling must be mainly used as a residence by the person (ie, a home).
- If the person has more than one home, the main home is the home with which the person has the greatest connection.

29. The Commissioner's guidance on the "permanent place of abode" test can assist in determining which property the seller has the greatest connection with. That guidance is in "IS 16/03: Tax residence" *Tax Information Bulletin* Vol 28, No 10 (October 2016): 2.

30. Land that is **"used… for a dwelling"** is not limited to the land on which the dwelling is situated or to the surrounding curtilage (like a yard and garden). Land used for a dwelling can also include other areas the seller uses frequently, repeatedly or customarily in connection with or for the benefit of the dwelling. In the Commissioner's view, for an area of land to be "used for a dwelling" the land must be actually used for the dwelling. It is the **actual use** of the land, **rather than any intended use**, that is relevant.

31. The extent to which residential land is used **in connection with or for the benefit of a dwelling** is a question of fact that turns on the circumstances of each case. Factors that may indicate land is being used for a dwelling include whether the land is:

- set aside exclusively for private residential purposes,
- being used for an activity that complements or adds to the enjoyment of the dwelling,
- clearly identifiable as being used in connection with or for the benefit of the dwelling, and
- incidental to the enjoyment of the dwelling.

32. In the case of a **lifestyle block**, **examples** of land that is used for a dwelling (other than the house and curtilage) are:

- areas set aside for growing food for domestic use,
- areas for pet animals, and
- areas used to enhance the enjoyment or aesthetic value of the dwelling (eg, in the context of an average-sized (4 ha) lifestyle block, a reasonable amount of park land or covenanted native bush that is used to provide a green vista, retaining or shelter would be an area that enhances the enjoyment of a dwelling).

33. Another example of land used for a dwelling is land used for hobby farming on a lifestyle block. For the purposes of this QWBA, hobby farming refers to a farming or agricultural activity undertaken by the seller on land that does **not** meet the definition of "farmland" (eg, because the area of the land used for the activity is too small to sustain a farming or agricultural business).

34. For the main home exclusion to apply, the land in the lifestyle block needs to have been **used predominantly** for a dwelling that was the seller's main home. This is a question of fact and the test is a physical area test. The test involves a comparison of the physical area of land used for the dwelling and the total area. "Predominantly" in this context means more than 50%.

35. The leasing or licencing of part of the lifestyle block to another person will not necessarily mean that that part is not used for the dwelling, as long as the other person's use of the land is complementary to the seller's enjoyment of the property (eg, where a neighbour has grazed some animals on the seller's land to keep the grass down) and the seller continues to use the land as a matter of fact.

36. However, in some cases, the leasing or licencing of part of the lifestyle block may mean that the seller is effectively excluded from using that part of the land as a matter of fact.

37. The Commissioner considers that it will typically be difficult for the seller to show that part of the seller's lifestyle block that is leased to someone else with exclusive possession is used for the seller's dwelling. If the area of land not used for the seller's dwelling exceeds 50% of the total area of the land the sale will be subject to the bright-line test.

38. From time to time, particularly where the split between the seller's private residential use of the land in the lifestyle block and their use of the land in the lifestyle block for other purposes is close, the nature and the importance of the different uses could be taken into account to determine the seller's predominant use. The Commissioner considers this is the best interpretation of the exclusion because it is consistent with the scheme of the land rules and the purpose of the provision. It also takes into account case law on the interpretation of words like "predominantly" in the context of the land rules.

39. The words "**for most of the time** the person owns the land" require a comparison between the length of time the land was predominantly used for a dwelling by the seller and the length of time the seller owned the land. "Most" means more than 50%.

Exceptions to the main home exclusion

40. There are two exceptions that may prevent the main home exclusion applying (see s CB 16A(2)).

41. These exceptions are considered in "QB 16/07: Income tax – land sale rules – main home and residential exclusions – regular pattern of acquiring and disposing, or building and disposing" *Tax Information Bulletin* Vol 28, No 9 (October 2016): 4. Briefly, the exceptions are where:

- The seller has already used the main home exclusion two or more times within the two years immediately preceding the bright-line date (eg, in the case of a sale of land, within 2 years of the date the sale agreement is entered into).
- The seller has engaged in a regular pattern of acquiring and disposing of residential property that was their main home.

Examples

The following examples assume that the property has been used as the seller's main home for all the time they owned the property and that the exceptions to the main home exclusion do not apply.

Example 1: Land that because of its area cannot be used as farmland

Marama had a 1 hectare property that she sold within the bright-line period. The property had a house that she used as her main home. The property also had a small area of grazing land and a larger area of native bush. She kept a few sheep on the grazing land to keep the grass down.

The property was not farmland because it wasn't being worked in a farming or agricultural business carried on by Marama. Nor, given the size of the property, could Marama argue it was capable of being worked as a farming or agricultural business. The property was a hobby farm, not farmland.

The main home exclusion is available to Marama because more than 50% of the area of the property was used for her dwelling. The grazing land was an area for her hobby-farming activity, and the area of native bush was used to enhance her enjoyment and the aesthetic value of her dwelling. Therefore, the sale of Marama's property within the bright-line period will not be taxed under the bright-line test.

Example 2: Plot of land that is farmland

Uri had a 5 hectare property that he used for a commercial rose growing business. A small area of the land is used for his house and the garden around it.

The property is farmland because it was being worked in Uri's agricultural business. The sale of Uri's property (including the house) within the bright-line period will not be taxed under the bright-line test because the land is not residential land.

Example 3: Part of property leased to an avocado grower

Tom and Jess had a 2 hectare property that they sold within the bright-line period. The land included 1.5 hectares of avocado trees with shelter belts. The balance of the land was used for a house that Tom and Jess used as their main home as well as a flower garden, a vegetable garden and a paddock for grazing Jess's two horses. The avocado trees were leased to an avocado-growing company that looked after the trees including spraying the trees, mowing between the rows of trees and picking the fruit. The lease gives exclusive possession to the avocado-growing company and Tom and Jess do not go into the avocado orchard.

The property was not farmland because:

- It was not being worked in an agricultural business carried on by Tom and Jess (rather, it was being worked in the avocado-growing company's agricultural business); and
- In this case, the 1.5 hectares of avocado trees was not of sufficient scale to be capable of being carried on as an avocado-growing business given the number of avocado trees on the land.

The main home exclusion is not available to Tom and Jess because less than 50% of the area of the property is used for their dwelling. The dwelling, its flower garden, the vegetable garden and the land for grazing the horses are all physically used for purposes in connection with the enjoyment of the dwelling,

rather than for any other purposes. However, most of the land (75%) was leased to the avocado-growing company and was not used for Tom and Jess's dwelling. Therefore, the sale by Tom and Jess of the property within the bright-line period will be taxed under the bright-line test.

References

Subject references

Bright-line test

Main home exclusion

Legislative references

Income Tax Act 2007, ss CB 6A, CB 6–CB 12, CB 16A, YA 1 ("business", "farmland", "main home" and "residential land")

Taxation (Annual Rates for 2017–18, Employment and Investment Income, and Remedial Matters) Act 2018, s 6(2)

Case references

CIR v Bruhns (1989) 11 NZTC 6,075 (CA)

Grieve v CIR (1984) 6 NZTC 61,682 (CA)

Other references

"IS 16/03: Tax residence", *Tax Information Bulletin* Vol 28, No 10 (October 2016): 2

"QB 16/07: Income tax – land sale rules – main home and residential exclusions – regular pattern of acquiring and disposing, or building and disposing" *Tax Information Bulletin* Vol 28, No 9 (October 2016): 4