Inland Revenue
Te Tari Taake

29 August 2019

QUESTION WE'VE BEEN ASKED

QB 19/13

Income tax – When does the business premises exclusion to the bright-line test apply?

This Question We've Been Asked (QWBA) explains the business premises exclusion that applies for the purposes of the bright-line test. It will be of interest to anyone selling their business premises on what might be residential land.

Question

When does the business premises exclusion to the bright-line test apply?

Answer

Land that has been used predominantly as business premises is not subject to the bright-line test, even if the land has a dwelling on it.

"Business premises**"** means land, typically including a building, together with any surrounding associated land, from which a person carries on a business. In some cases, land can be business premises even if there is no building on the land.

Land will be used predominantly as business premises where:

- more than 50% of the area of the land has been used as business premises; and
- the land has been used as business premises for more than 50% of the time the seller owned it.

Key provisions

Income Tax Act 2007:
ss CB 6A and YA 1 (definition of "residential land").

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

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.

Business premises: means land, typically including a building, together with any surrounding associated land, occupied by a person mainly to carry on a business. However, in some cases, land without a building may also qualify as business premises.

Sale: The bright-line test applies to all types of disposals, including sales.

Explanation

The scope of this QWBA

1. This QWBA focuses on the business premises exclusion to the bright-line test. There is a separate business premises exclusion that is relevant where the sale of land is potentially taxable under other land taxing provisions in the Act (ss CB 6 to CB 11). These two business premises exclusions are briefly compared at [24]. The exclusion from ss CB 6 to CB 11 is discussed in more detail in "QB 19/14: Income tax – When does the business premises exclusion in s CB 19 apply to preclude land sales from being taxed under ss CB 6 to CB 11?".

Bright-line test

2. The bright-line test under s CB 6A taxes the sale of residential land within the bright-line period.

3. 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 either 2 years or 5 years, depending on when the seller first acquired an interest in the land.

4. The bright-line test under s CB 6A applies only where none of the land taxing rules in ss CB 6 to CB 12 apply (for example, s CB 6, which applies to the sale of land acquired for the purpose or with the intention of re-sale).

Definition of "residential land"

5. "Residential land" is defined in s YA 1 as meaning:

   - land with a dwelling on it;
   - land for which the owner has an arrangement to erect a dwelling; or
   - bare land that may be used for erecting a dwelling under the relevant operative district plan.

6. However, "residential land" does not include land "used predominantly as business premises".

7. In most cases, a person selling business premises will not need to rely on the business premises exclusion because usually the land will not meet the requirements to be "residential land". This is because:

   - business premises land will not usually have a dwelling on it;
   - the landowner will not usually have an arrangement to erect a dwelling on the land; and
   - business premises land will not usually be "bare land" (which would come within the definition of "residential land" if it may be used for erecting a dwelling under the relevant operative district plan).

8. Because most business premises land being sold will not meet the criteria to potentially be "residential land", the carve out for business premises will not usually need to be considered, and the land will not be subject to the bright-line test in s CB 6A.

9. The most likely situation where the business premises exclusion needs to be considered is where a person sells land that has both a dwelling and business premises on it. The presence of a dwelling means the land may fall within the definition of "residential land" and potentially be subject to the bright-line test. However, if the land is used predominantly as business premises, it will not be "residential land" as defined. Another situation where a person may need to consider the business premises exclusion is where business premises are on bare land that may be used for erecting a dwelling under the relevant operative district plan. Situations in which a person sells business premises land for which they have an arrangement to erect a dwelling are likely to be rare.

Meaning of "dwelling"

10. A "dwelling" is defined in the Act as being "any place used predominantly as a place of residence or abode, including any appurtenances belonging to or enjoyed with the place". However, for the purposes of s CB 6A and the definition of "residential land", a "dwelling" does not include any of the following, in whole or part:

- a hospital;
- a hotel, motel, inn, hostel or boardinghouse;
- a convalescent home, nursing home, or hospice;
- a rest home or retirement village; or
- a camping ground.

Meaning of "business premises"

11. Business premises is not defined in the Act for the purposes of the bright-line test and the definition of "residential land". "Premises" is defined in the *Concise Oxford English Dictionary* (12th ed, Oxford University Press, New York, 2011) as:

> A house or building, together with its land and outbuildings, occupied by a business or considered in an official context.

12. At common law, "business premises" can refer to a variety of places from which a business is carried on, whether just buildings, buildings and associated land, or bare land. (*Case Y10* (2007) 23 NZTC 13,097 (TRA); *Thames Water Ltd v Hampstead Homes Ltd* [2003] 1 WLR 198 (CA); *Gardiner v Sevenoaks Rural District Council* [1950] 2 All ER 84 (QB); *C of T v Nightcaps Coal Company (Ltd)* (1909) 29 NZLR 885 (SC)).

13. The Commissioner considers that while business premises will typically include a building, there may be instances where land without a building is business premises. For instance, a quarry may be business premises even if it does not have a building on it. It will be up to the taxpayer to show that the land is business premises.

14. As noted above, "business premises" is a place from which a business is carried on. Whether there is a "business" will be determined using the business test set out in *Grieve v CIR* (1984) 6 NZTC 61,682 (CA). "Carrying on" a business from a location, requires some or all of the activities of the business to be conducted continuously or habitually from there. For the purposes of the s CB 6A business premises exclusion, the business premises may be those of the landowner or of a third party such as a tenant or tenants.

15. Once the land is found to have business premises on it, the s CB 6A business premises exclusion requires that the land as a whole must have been used predominantly as business premises. "Predominantly" in this context means more than 50%. Land will have been used predominantly as business premises where:

- the physical area of land used as business premises is more than 50% of the total land area; and
- that land has been used as business premises for more than 50% of the time the landowner has owned the land.

16. Where a building has multiple storeys, the floor area of each storey is included in the calculation of total land area.

17. From time to time, particularly where the split between the business premises use of the land and the land's other uses is close, the nature and the importance of the land's different uses should be considered to determine which of the uses is the predominant use. This is the approach the courts have taken to the meaning of "predominantly" (see, for example, *Paddico (267) Ltd v Kirklees Metropolitan Council* [2011] EWHC 1,606 (Ch)).

18. Because the definition of "business premises" requires the land to have been used "predominantly" as business premises, the Commissioner considers the exclusion applies on an all or nothing basis. Therefore, if the land is predominantly used as business premises, all of the land is excluded from the meaning of residential land. If the land is not used predominantly as business premises, then the exclusion does not apply, and all of the land is residential land and potentially subject to the bright-line test.

Conclusion

19. In most cases, a person selling business premises will not need to consider the business premises exclusion to the bright-line test. This is because for most business premises, it is unlikely that:

- there will be a dwelling on the land;
- the landowner will have an arrangement to erect a dwelling on the land; or
- the land will be bare land (which would come within the definition of "residential land" if it may be used for erecting a dwelling under the relevant operative district plan).

20. However, even if one of the above is the case, the land will fall out of the definition of "residential land" if it is used predominantly as business premises, so the sale would not be subject to the bright-line test.

21. Using land as business premises means business activities are continuously or habitually conducted from that land. The business premises do not need to be the landowner's own business premises; they can, for example, be the business premises of a tenant or tenants.

22. Land will be used predominantly as business premises if more than 50% of the total land area is used as business premises for more than 50% of the time the landowner has owned the land.

23. The exclusion applies on an all or nothing basis. If the land is used predominantly as business premises, then all of the land is excluded from the bright-line test. If the land is not used predominantly as business premises, the exclusion will not apply to any part of the land.

Comparison of the s CB 6A and s CB 19 business premises exclusions

24. As noted at [1], the business premises exclusion to the bright-line test is not the only business premises exclusion in the land taxing rules. There is a separate business

premises exclusion relevant where the sale of land is potentially taxable under other land taxing provisions in the Act (ss CB 6 to CB 11). Although these two exclusions are both described as "business premises exclusions", they are not the same. "QB 19/14: Income tax – When does the business premises exclusion under s CB 19 apply to preclude land sales from being taxed under ss CB 6 to CB 11?" discusses the application of the s CB 19 exclusion in more detail. In short, the main differences between the business premises exclusion to the bright-line test and the s CB 19 business premises exclusion are as follows:

- Section CB 19 relates to the land taxing provisions from ss CB 6 to CB 11. The bright-line business premises exclusion applies only to s CB 6A (the bright-line test).
- Section CB 19 applies only to land that is the landowner's business premises (and land reserved with the premises for the use of the business). The bright-line business premises exclusion potentially applies where someone uses the land as business premises.
- Section CB 19 specifically requires the landowner to have acquired and occupied or erected and occupied the relevant business premises mainly to carry on a substantial business. For the bright-line business premises exclusion, the premises do not have to be those of the landowner and the business does not have to be substantial.
- Section CB 19 applies to the extent that the land is business premises (or land reserved with the premises for the use of the business), while the bright-line business premises exclusion applies to all of the land sold, or not at all.
- Section CB 19 does not apply where the landowner has engaged in a regular pattern of buying or building business premises and selling them. The bright-line business premises exclusion does not have such an exception.

Examples

25. The following examples explain how the law applies.

Examples

Example 1: Business premises exclusion not relevant as requirements to be "residential land" **not met**

On 1 August 2018, Raj, a dentist, purchases a property with a villa on it. The previous owner had lived in the villa for many years. Raj fits the villa out as a dentist surgery and carries on his dentistry business from there. Three years later, Raj sells his dentistry practice and the villa and moves overseas. During the time Raj owned the villa, nobody lived in it, and Raj did not have an arrangement to erect a dwelling on the property.

Shortly after selling the villa, Raj hears about the bright-line test and asks his lawyer, Ruby, whether the sale might be subject to tax since the villa was previously a residential home.

Ruby explains that the sale of the villa is not subject to the bright-line test because the property does not meet the definition of "residential land". This is because:

- the property did not have a dwelling on it;
- Raj did not have an arrangement to erect a dwelling on the property; and
- the property was not "bare land" that may be used for erecting a dwelling under the relevant operative district plan.

Ruby explains that although the villa might look like a dwelling, it was fitted out as a dentist surgery not as a place of residence or abode. Ruby also notes there is a business premises exclusion to the definition of "residential land", but in Raj's case, this exclusion is not relevant because the property did not fall within the requirements to potentially be "residential land" in the first place.

Example 2: Land with a building that is partly business premises and partly a dwelling excluded from bright-line as predominantly business premises

Dave purchases a building in the suburbs that has a downstairs retail space and a single bedroom flat upstairs. The downstairs retail space is just over twice the size of the upstairs flat. Dave leases the retail space to Andy, who runs a florist business from it. The upstairs flat is rented to Mary under a residential tenancy.

A year later, Dave decides to move overseas and sells the building. The property meets the first requirement of the definition of "residential land" because the upstairs flat is a dwelling. However, the downstairs retail space is the business premises of the florist. Because the business premises is more than twice the size of the upstairs flat, the property is used predominantly as business premises. Accordingly, the property is not "residential land". Therefore, the sale of the property is not subject to the bright-line test.

Example 3: Land with business premises and stand-alone residence excluded from bright-line as business premises

Milk Mixer Ltd buys a large milk-processing factory. On the property is a small house where the factory's caretaker lives. Because there is a dwelling on the property (the house), the land is potentially "residential land", so potentially subject to the bright-line test. However, because the land is predominantly (more than 50%) used as Milk Mixer Ltd's business premises, all of the land is excluded from the definition of "residential land", so the bright-line test would not apply if the property were sold within the bright-line period.

Example 4: Land with business premises and stand-alone residence excluded from bright-line as predominantly business premises

Wayne buys a property that has a three-bedroom house and large stand-alone workshop on it. Wayne lives in the house with his family and operates a surfboard-building business from the workshop. Wayne's workshop and associated land make up 60% of the total land area of the property and has been his business premises since he purchased the property. Because the property has a dwelling on it (the house), the property meets the initial definition of "residential land".

Wayne sells the property within the bright-line period. Although the property meets the initial part of the definition of "residential land", it subsequently falls outside the definition because the land is predominantly used as business premises. This means the sale of the property is not caught by the bright-line test.

If the land was not predominantly used as business premises, it is still possible that the property sale would nonetheless be excluded from the bright-line test under the "main home" exclusion (s CB 16A). For details on how the "main home" exclusion in s CB 16A applies, see "QB 18/16: Income tax – bright-line test – main home exclusion – sale of subdivided section".

However, if the property was owned by Wayne's family trust, the "main home" exclusion would only be available if the principal settlor of the trust does not have a main home (e.g. if Wayne's late father settled the trust), or if the principal settlor does have a main home, then that main home is the one being sold (e.g. if Wayne settled the trust and lives in the house as a beneficiary of the trust). In this context, the principal settlor is the settlor whose settlements on the trust are the greatest or equal greatest, by market value.

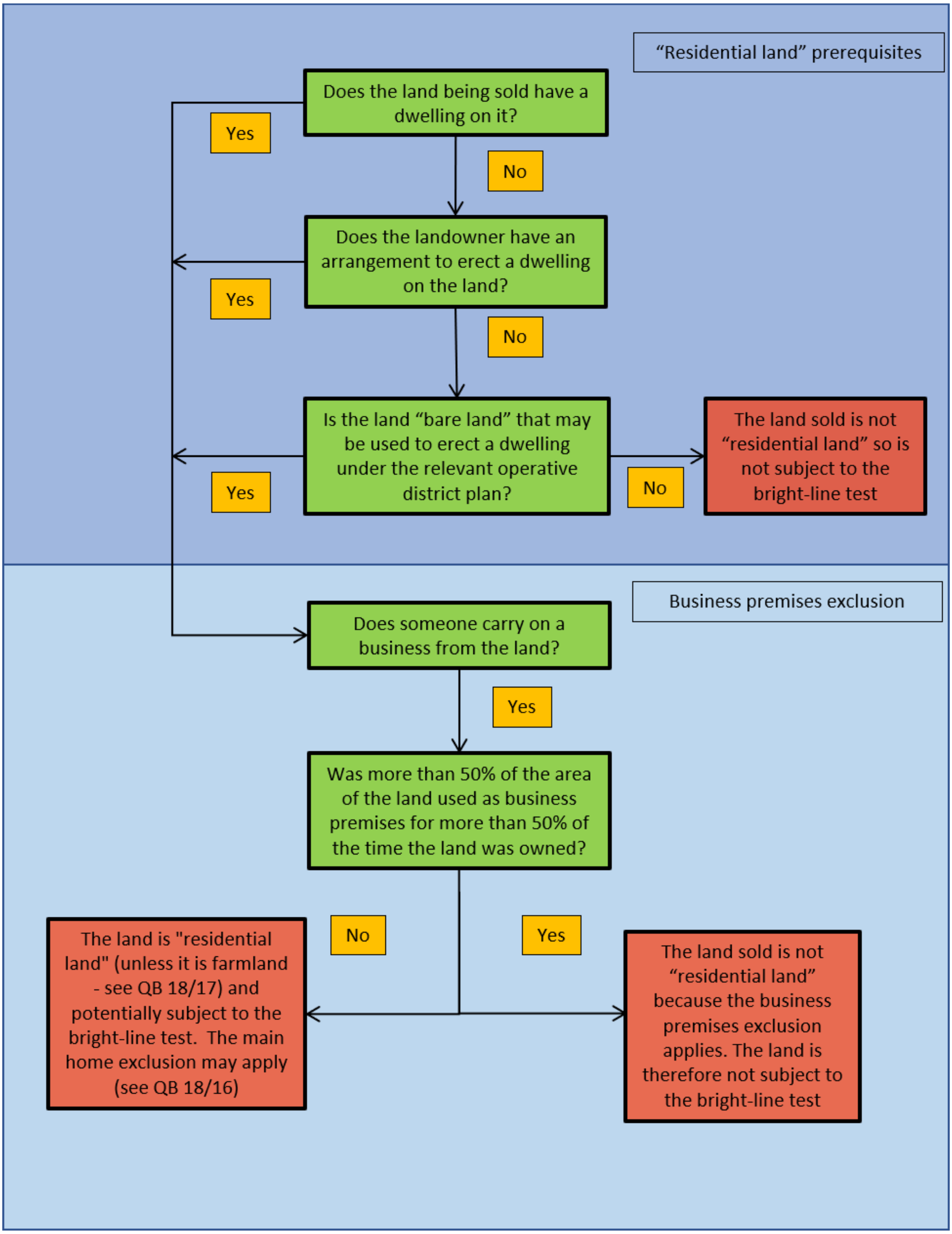
Example 5: Land with business premises and stand-alone residence not excluded from bright-line as not predominantly business premises

Jerome buys an investment property with a stand-alone studio at the front and a three-bedroom house at the rear. Jerome immediately rents the property to Denise. Denise uses the studio for her legal practice and lives in the house with her family. The studio makes up 30% of the total land area of the property and is used as Denise's business premises 100% of the time Jerome owns the property. Because the property has a dwelling on it (the house), the property meets the initial definition of "residential land".

Jerome sells the property within the bright-line period. Although the property is used as business premises, it is not used "predominantly" (more than 50%) as business premises. Therefore, the property is not excluded from the definition of "residential land", so is caught by the bright-line test. Unlike Wayne in Example 4, Jerome does not live in the house on the property. Accordingly, the "main home" exclusion (s CB 16A) is not available.

Appendix

The following flowchart sets out the steps to determine whether the bright-line test and business premises exclusion apply to a sale of land within the bright-line period:



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References

Subject references

Bright-line test

Business premises exclusion

Legislative references

Income Tax Act 2007, ss CB 6A, CB 6–CB 12, CB 16A, CB 19, YA 1 (“dwelling”, “residential land”)

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

Case references

C of T v Nightcaps Coal Company (Ltd) (1909) 29 NZLR 885 (SC)

Case Y10 (2007) 23 NZTC 13,097 (TRA)

Gardiner v Sevenoaks Rural District Council [1950] 2 All ER 84 (QB)

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

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Thames Water Ltd v Hampstead Homes Ltd [2003] 1 WLR 198 (CA)

Other references

Concise Oxford English Dictionary (12th ed, Oxford University Press, New York, 2011).

“QB 18/16: Income tax - bright-line test - main home exclusion - sale of subdivided section”, *Tax Information Bulletin* Vol 31, No 1 (February 2019): 43.

“QB 18/17: Income tax - bright-line test - farmland and main home exclusions - sale of lifestyle blocks”, *Tax Information Bulletin* Vol 31, No 1 (February 2019): 48.

“QB 19/14: Income tax – When does the business premises exclusion in s CB 19 apply to preclude land sales from being taxed under ss CB 6 to CB 11?”, *Tax Information Bulletin* Vol 31, No 9 (Oct 2019)