

# kendons

CHARTERED ACCOUNTANTS

## YOU & GST ON YOUR REAL ESTATE TRANSACTIONS

One of a series of business  
advisory publications  
available on request

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The information presented in this brochure is necessarily of a general nature and should not be relied upon as a substitute for specific advice. For advice on, or assistance with any of the matters raised, please contact

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## **Introduction**

Despite all the form filling required to record GST outputs (income) and inputs (expenses) moving through business affairs, GST is basically a very simple tax. Unfortunately it becomes complex around the edges of the few items which are excluded from its claws by being exempt, zero rated, or charged at a non-standard rate. Whether 'IN or OUT' often raises complex issues of interpretation, and hence a large number of cases are considered by the Courts, with a very substantial proportion relating to real estate transactions.

Undoubtedly this arises from the generally large monetary value of each transaction, the consequent funding issues if GST is involved, and the wide variety of uses which may be made of real estate.

Consequently, extreme care must be taken by all parties in conducting their negotiation of the terms of the contract. Professional advice should be sought before contracts are signed.

## **GST Overview**

The consumption of goods and services in New Zealand generally attracts GST at the rate of 12½% (one-ninth of the sale value) on transactions made by registered entities.

Output tax is charged by a registered entity on the supply of goods and services. Input tax on the purchase of goods and services is offset against any output tax. Input tax deductions can only be claimed if the goods and services are acquired for the principal purpose of making taxable supplies. To claim an input tax credit, a purchaser must hold tax invoices for all items over \$50. A GST registered vendor must provide a GST registered purchaser with a tax invoice within 28 days of the purchaser requesting one.

Second-hand goods acquired by a registered entity from an unregistered entity are deemed to have a GST content.

GST registration is required within 21 days of commencing a taxable activity where the annual value of supplies is expected to exceed \$60,000 in any 12 month period with returns being required as:

<u>Annual Turnover</u>	<u>Taxable Periods (months)</u>	<u>Accounting Basis</u>
to \$250,000	1 or 2 or 6	Payments or Invoice or Hybrid
to \$2 million	1 or 2	Payments or Invoice or Hybrid
to \$24 million	1 or 2	Invoice or Hybrid
over \$24 million	1	Invoice or Hybrid

The accounting basis results in the following amounts being included in the returns:

<u>Accounting Basis</u>	<u>Tax on Income (Output Tax)</u>	<u>Tax on Expenses (Input Tax)</u>
Payments	Amounts received In a taxable period	Payments made in a taxable period
Invoice	Earlier of – Date of Tax Invoice Receipt of Payment	Earlier of – Date of Tax Invoice Making of Payment
Hybrid	Earlier of – Date of Tax Invoice Receipt of Payment	Payments made in a Taxable Period

A supply by a payments basis registrant in excess of \$225,000 (including GST) and where payment is deferred for over one year, is required to be returned on an invoice basis for that item.

A change of taxable period is not required if the \$1.3 million threshold is exceeded as a result of the cessation or substantial reduction in the size of a taxable activity or the replacement of an asset used in the activity.

The following supplies and services are not subject to GST:

- items for personal consumption
- residential accommodation

- renting of leasehold land for the principal use of residential accommodation
- financial services

Going concern sales, between registered entities, are included but at a nil (zero-rated) GST rate.

An activity is taxable when it is carried on continuously or regularly to supply goods and services for consideration. It need not necessarily be carried on for the purpose of making a profit and hence a taxable activity could exist for GST purposes without constituting a business for income tax purposes which requires an intention to make a profit.

## **The Time of Supply**

The rules relating to time of supply determine when an item is to be included in a GST return.

The general rule is that it is the earlier of:

- the time an invoice is issued, or
- the time any payment is received by the supplier

‘Any payment’ includes a deposit even if an invoice has not been issued, and it includes payments made to an agent of the vendor and applied for the benefit of that vendor. Hence payments made to a real estate agent from which commission has been deducted have been applied for the vendor’s benefit and are deemed to be payments received by the vendor. Payments made to an independent third party as ‘stakeholder’ cannot be applied for the vendor’s benefit until the contract becomes unconditional and are not deemed to be received by that vendor until the contract is unconditional.

For real estate the general time of supply is the earlier of:

- the execution of an unconditional contract, or
- the receipt of a deposit applied to the benefit of the vendor

Generally the execution of an unconditional contract will become the time of supply. If an invoice is issued while a contract is conditional that invoice will become the time of supply.

The receipt of a deposit by payments based entities (annual sales of less than \$1.3 million) is included in the GST return for that period. For Invoice and Hybrid basis entities **THE WHOLE** of the sale price is included in the return for the period when the deposit is received or when the contract becomes unconditional.

Building contract progress payments are subject to a special rule and GST is payable on the earlier of the receipt of a progress payment or the issue of an invoice.

## **The Value of Supply**

The taxable value of a transaction between arms length entities is the consideration given less the GST ie  $\text{consideration} - \text{GST} = \text{value of supply}$ .

Where non-monetary consideration is involved the value of supply is the open market value of the consideration excluding GST.

Transactions between associated persons are deemed to be made at open market value excluding GST even if the contract is for a lesser or nil amount.

Associated persons are:

- two or more companies with a common shareholding in excess of 50% or where control is exercised in any other way
- a company and shareholder where the shareholding is 25% or more
- two persons who are relatives
- a partnership and a partner in that partnership, or any other person who is associated with a partner
- a trustee and the settlor of the trust or a beneficiary of the trust
- trusts where a person is a settlor of each trust

## **Principal Purpose and Apportionment**

Input tax deductions can only be claimed if the goods and services are acquired for the principal purpose of making taxable supplies.

Case law has held:

- purpose means the object or end which is in mind and it is not synonymous with motive or intention
- principal means the main or primary or fundamental purpose and it does not mean more than 50%

Accordingly where there are more than two purposes involved the principal purpose could be less than 50% of the total purpose.

Input tax deductions are therefore only available if the main use is in the course of making taxable supplies.

Some cases have allowed an input deduction for the purchase of a domestic dwelling where renovations and alterations have been made to customise the building for business use – a sculptor, an interior designer, a boutique saddlery.

Adjustments are required where supplies initially acquired for the principal purpose of making taxable supplies are subsequently used for a non-taxable private or exempt purpose.

Where the item is subsequently applied exclusively for private use GST is payable on the lesser of the GST inclusive cost or open market value.

A similar one off adjustment will arise when a revenue item is applied to private use. However if the item is a capital one applied partly for private use on a continuous basis, the adjustment would be required in each subsequent return. A one time adjustment can be made for assets costing up to \$18,000. On the eventual sale, items which have been applied partly for private use, will still be subject to output tax on the sale value.

## Zero Rating as a Going Concern

The effect of zero rating is that the purchaser does not pay GST to the vendor on settlement, and therefore cannot obtain a refund from IRD.

In entering into a contract both parties must carefully consider the GST implications of the proposed sale.

For zero rating to apply:

- there must be a taxable supply
- the vendor and the purchaser must be GST registered entities
- there must be a sale of either the whole or a stand-alone part of a taxable activity
- both parties must agree in writing that the sale is of a going concern

The going concern exemption requires:

- sale of the whole or part of a taxable activity, such part being capable of separate operation.
- that all goods and services necessary for the continued operation of the activity must be supplied.
- the vendor to carry on the activity until it is transferred.

There is however no obligation on the purchaser to continue the operation after settlement and it may be immediately closed down. The underlying intention of the definition is that the purchaser is able to continue the operation the day after settlement without being required to acquire further resources.

Hence the sale of a commercial property to the sole tenant of the building would not meet the going concern test as not all items necessary for the continued operation pass with the sale, because it is not possible for the tenant to lease the building to itself. At settlement the leasehold and freehold interests would merge and the supply would cease.

The transfer of a commercial building, which is only 5% tenanted, would appear to meet the test. However the IRD view is that generally a 50% tenancy is required to meet the test.

The going concern test is applied at the GST time of supply, but the vendor must carry the business on up to settlement.

If the vendor is not a GST registered entity the sale is not taxable and therefore cannot be zero-rated. It is possible for the vendor to be deemed to be a GST registered entity where the projected income exceeds \$60,000 in any 12 month period even though registration has not been effected. The going concern sale proceeds are not included in calculating the \$60,000 threshold.

In a sale between an unregistered GST entity and a GST registered entity, the registered purchaser may be able to claim an input tax credit on the basis of the property being second-hand goods, eg in the case of a sale of a residence to a developer for refurbishment or redevelopment.

If the purchaser is not GST registered and zero rating is to apply, then the purchaser must register within 21 days of the commencement of the taxable activity, with such commencement date being the earlier of the issue of an invoice or payment of a deposit rather than the date of settlement of the sale.

While IRD accepts that a deemed registration occurs when the turnover exceeds the \$60,000 registration, threshold registration is required, and must be completed before settlement.

It is desirable within the agreement for sale and purchase for both the vendor and purchaser to warrant to each other that they are registered entities.

There is a proposal in an IRD draft ruling issued in October 1998 that the sale of a leased commercial dwelling may be zero-rated where:

- the lease of the property is to some person other than the purchaser
- the terms of the lease must have commenced before the date of the transfer and the lease must exist past the transfer date
- the property sale must take place subject to the lease

## Agreements for Sale and Purchase

In addition to the particular GST provisions, general legal doctrines and principles of contract law are applicable. The Courts have stated that parties to a contract cannot influence the application of GST by the way they may agree to describe the purchase price. GST is paid to IRD and not between the parties to the contract. This has resulted in the generally preferred wording 'plus GST (if any)'. Nevertheless, it is essential that the parties fully consider the GST effects of the transaction before they enter into any agreement for they can be left with unintended and unexpected consequences.

### *Purchase Price stated to Include GST*

The GST element will be the tax fraction of the consideration. The vendor must account for one-ninth of the price as output tax, and a registered purchase can claim back one-ninth as input tax. 'Inclusive of GST' does not affect the issue of whether or not the transaction is subject to GST.

### *Purchase Price Stated to Exclude GST*

In contract law this may not necessarily mean that GST is not recoverable from the purchaser.

### *No Mention of GST*

The general rule is that the price includes GST where it is not mentioned.

### *Purchase Price Stated as Zero Rated for GST*

For going concern transactions where the parties have agreed that the supply is that of a going concern, but it is subsequently found that zero rating is not applicable, the vendor can recover the GST from the purchaser.

### *Purchase Price Stated as 'plus GST (if any)'*

Case law has determined that this is a clear and unequivocal acceptance by the parties that GST should, if applicable, be added to the price.

### ***Suggested Wording***

'**plus GST (if any)**' is the preferred wording for commercial property transactions as it fixes the amount received and payable for both parties where the purchaser is entitled to an input credit.

The Auckland District Law Society has stated that 'plus GST (if any)' is preferable and has included it in their standard forms.

A GST registered purchaser expecting to claim a second-hand goods input credit, may require a 'GST inclusive' wording to protect the position if it eventuates that the transaction is subject to GST.

***Any purchaser acquiring real estate including a dwelling, should be aware that GST may be imposed on the portion relating to the dwelling, if the vendor has previously received an input credit. Extreme care is required where the wording is either 'plus GST' or 'plus GST (if any).'***

This often applies on the purchase of a farm property.

Residential transactions will generally use 'inclusive of GST (if any),' to ensure that the purchaser is not liable for any further amount, if the vendor is liable to pay GST on the sale.

Transactions involving options are treated in the same way as other transactions.

Where a purchaser fails to settle under an unconditional agreement for sale and purchase and forfeits a deposit to the vendor, the vendor is deemed to have made a taxable supply of the deposit and is liable to pay any GST output tax to IRD.

Apportionments of income and outgoings, made by solicitors on the settlement of a real estate transaction, are calculated in terms of the underlying unconditional sale contract. Where the transaction is zero-rated as a going concern, the apportionments of all income and outgoings will be calculated on a GST exclusive basis. Where the vendor has received rental income from the tenant after providing the tenant with a tax invoice, and subsequently pays a portion to the purchaser after settlement, then the purchaser should provide a tax invoice to the vendor.

## Land as 'Second-hand Goods'

A registered entity purchasing second-hand goods for use in a taxable activity, is permitted to deduct a portion (one-ninth) of the purchase price where:

- the goods are in New Zealand
- the goods are purchased for the principal purpose of making taxable supplies
- the supply is a sale by an unregistered entity
- **payment** has been made in the period of the GST return in which the input credit is claimed

The Courts have generally accepted that land qualifies for the second-hand goods input credit.

Where the vendor and purchaser are associated persons GST is calculated on the lower of:

- the GST originally paid by the supplier
- the purchase price
- the open market value

An IRD policy statement for the sale by an unregistered entity of land made available for use by an associated registered entity, states that for the purchaser to claim a second-hand goods input credit the following are required:

- there must be a sale of the land
- payment must have occurred as evidenced by
  - an acknowledgement of debt
  - a cheque swap
  - offset against an existing current account debt
- the vendor cannot be liable to register for GST, ie the \$60,000 threshold has not been exceeded from the payment by the occupier of rent, mortgage outgoings, interest rates and development costs

## Residential Accommodation

The supply of residential accommodation is exempt and GST is not charged on any building used mainly as a private residence. This includes:

- the letting of a house or flat as a dwelling
- the supply of a dwelling under a service or occupancy agreement, or a licence to occupy
- the occupancy cost of a unit or apartment in a rest home complex or retirement village
- a farmhouse let to a sharemilker
- the letting of residential flats in commercial properties
- the provision of accommodation for a night watchman in an industrial building

The dwelling definition includes not only the building but any 'appurtenances belonging thereto and enjoyed with it'. Accordingly, the surrounding curtilage is included in the exemption.

Where the land is used for a mixture of residential and other purposes an apportionment is required and this will usually be made on the basis of the areas involved.

The exemption does not extend to 'commercial dwelling' such as:

- hotels, motels and camping grounds
- long-term accommodation in a hospital

GST is not charged on ground rentals of leasehold land where the buildings are used for residential accommodation.

The exemption does not apply to consideration received for:

- the initial grant of a lease of land.
- the sale of a lessor's interest in the land.
- the sale of previously leased land where the lessee has erected a residential dwelling.

GST is not charged on the sale of a dwelling, nor on a lessor's interest in leasehold land, where the vendor has leased the land for more than 5 years exclusively for residential accommodation.

## Buildings Occupied as Dwellings

IRD policy is that the taxable supply of buildings used as a dwelling is not subject to GST because the dwelling is either a private asset or an exempt activity. Accordingly there is no need to make private use adjustments in the various GST returns. The policy applies to:

- Farm houses
- Permanent farm employees accommodation
- Flats above shops
- Accommodation in a separate and identifiable building
- Caretakers' flats
- Ministers' manses

**Example 1:** A farm property consisting of a house and twenty hectares of land is supplied by a registered person. The house, gardens etc occupy one hectare of the land. The values of the house and land, excluding GST are \$90,000 and \$50,000 respectively.

	\$
Dwelling & Curtilage	
1/20 x \$50,000	2,500
	<hr/>
Value of house	90,000
Proportion of land	2,500
	<hr/>
Not subject to GST	92,500
	<hr/>
Total land value	50,000
Less Proportion relating to house	2,500
	<hr/>
Subject to GST	47,500
	<hr/> <hr/>

**Example 2:** A shop has a flat used as a dwelling above it. The area of the shop is 800 sqm and the area of the flat is 400 sqm. The value of the land and buildings is \$150,000 excluding GST.

Value of dwelling  $\frac{400}{1,200} \times \$150,000 = \$50,000$  Not subject to GST

Value of shop  $\frac{800}{1,200} \times \$150,000 = \$100,000$  Subject to GST

**Example 3:** The top storey of a 14-storey office block is the caretaker's flat. All storeys are the same size. The value of the land and buildings is \$2,800,000 excluding GST.

1/14 x \$2,800,000 = \$200,000 Not subject to GST

13/14 x \$2,800,000 = \$2,600,000 Subject to GST

## Commercial Dwellings

A commercial dwelling is:

- a hotel, motel, inn, hostel or boarding house
- a camping ground
- a convalescent home, nursing home, rest home, or hospice
- any establishment similar to the above

Where the stay in a commercial dwelling exceeds four weeks the GST rate is reduced to 7½% (60% of 12½%). It is applicable only to the basic room rate after the first four weeks and not any incidental services such as meals, laundry and tolls.

A residential establishment is:

A commercial dwelling in which at least 70% of the occupants are expected to reside for at least 4 weeks. If the stay is initially agreed to be in excess of 4 weeks then a lower rate is applicable from the commencement of occupation. It includes a hospital, and may also include private hospitals and rest homes.

IRD has calculated the following rates to be applied to the total fees charged by residential establishments.

Rest Homes	10.25%
Private Hospitals	10.75%

## Property Developers and Temporary Residential Renting

GST registered property developers or builders may rent out residential dwellings or units while the property is marketed for sale.

Despite Case Law, IRD policy applies the principal purpose test to the initial acquisition and there is either a full input credit or no input credit available depending on whether the principal purpose was development or domestic rental.

The policy is:

*Initial Purchase* Full input allowed where the property is acquired for the purpose of principal purpose of resale.  
No input allowed where the purpose of acquisition is to rent the property.

*Subsequent use* An output adjustment is required while the principal purpose remains resale but rental income is derived pending sale.

*Output Adjustment* Required on a return by return basis as one-ninth of the lesser of  
a) market rental for the property;  
or  
b) 2% of the cost of the building applied to making the supply.

*Example*

Purchase	120,000
Development costs	<u>100,000</u>
Total building costs	220,000
2%	4,400
2 month return	733.33
GST content	81.48
or rental for 2 months	1,200
GST content	133.33

*Eventual Sale* The sale made in the course of the taxable activity will be subject to GST.

*Change of Purpose* If the principal purpose changes from property development to domestic occupation a one-off output adjustment of one-ninth of the lesser of the cost of the property or the open market value is required.

## **Holiday Homes/Homestays/Farmstays/Serviced Apartments**

IRD released a draft interpretation statement in 2006 that stated in most cases holiday homes, homestays, farmstays and serviced apartments are not taxable activities and will not be subject to GST.

To claim input credits a GST registered entity must satisfy IRD that:

- a taxable activity is conducted
- the inputs were incurred for the principal purpose of making taxable supplies

A taxable activity involves:

- registration of the entity.
- the activity being carried on continuously or regularly.
- the intention to supply for consideration goods and services but the activity need not be carried on for profit.

Whether a taxable activity is being carried on, and whether voluntary registration will be accepted if the turnover is less than the \$60,000 threshold, will involve an examination of relevant factors such as:

- feasibility studies, business plans, local authority consents
- type, size and design of the home
- location
- alterations made
- nature of the local tourist industry
- time available and applied to the activity
- availability of accommodation over a sustained period
- demonstration of continuing commitment to the activity
- levels of occupation since registration
- future bookings
- ability to provide accommodation to more than one group of people at any one time

IRD is empowered to cancel a registration where it considers that a taxable activity is not being conducted. Such a cancellation may be backdated to the date of the initial registration.

The principal purpose test considers the object or end use that the registered entity is focused upon and means the main or primary, or fundamental purpose. It is not synonymous with motive or intention, and does not necessarily mean more than 50%. Where there are only two possible uses, homestay and domestic use, the principal purpose must be more than 50%. When the principal purpose is making taxable supplies all input tax is recoverable even if there is a partial use of less than 50% in the domestic use.

Generally a formula will be applied to determine the principal use and it recognises that some areas will have a use shared by both purposes.

$$\frac{\text{Exclusive Homestay Area} + 50\% \text{ of Shared Area}}{\text{Total Area of Home}} = \text{Percentage Taxable Use}$$

The 50% factor for the shared area may not be an appropriate reflection of the principal purpose use of shared areas in some circumstances, eg if homestay occupation is only available for part of the year, or on a restricted basis. Based on particular facts, it may be possible to demonstrate a principal purpose even if the percentage use is slightly less than the 50% level.

The formula is also applied to additions and renovations. While curtilage is not included in the formula, its use may in some cases affect the calculation, eg exclusive use of a swimming pool or tennis court.

Regardless of the partial application of the home for private purposes, GST will be payable on a subsequent sale of the property where an input credit was allowed on the initial purchase or alteration and extension. Such alteration or extension will require apportionment when sold.

Deregistration or ceasing operation will also mean a claw back of the various input deductions.

Continuing operating expenses will require apportionment on general GST principles to reflect the domestic element.

## Family Home Subdivisions

Despite a number of cases and an IRD policy statement in August 1995, the position of subdividing a home section into smaller lots remains uncertain. While the variety of situations which could be involved compounds the uncertainty, the basic problem is the definition of a taxable activity and whether what is done does in fact constitute a taxable activity.

A judgement from the Court of Appeal adopted the following approach:

- whether an activity is carried on continuously was entirely different from whether it contained a number of sequential steps;
- the test was one of fact and degree requiring an overall view of the relevant activity;
- that it was not desirable for the Court to issue guidelines on what subdivisions comprise a 'taxable activity'.

This generates uncertainty as to where the borderline between 'IN' and 'OUT' is positioned.

The Court of Appeal case establishes, and IRD accepts, that a subdivision of land into two lots involving no development work does not by itself amount to a taxable activity. IRD accepts that the sale of the new section containing the original home is not part of the taxable activity and GST would not be charged.

However IRD considers that the process of subdivision being carried out on a regular or repeated basis does constitute a taxable activity, even if each subdivision is not a taxable activity in its own right.

Case Law only assists by requiring an assessment to be made of the full facts of each case, and has held in the particular circumstances that two extra sections were 'OUT' and four extra sections were 'IN'.

IRD policy is:

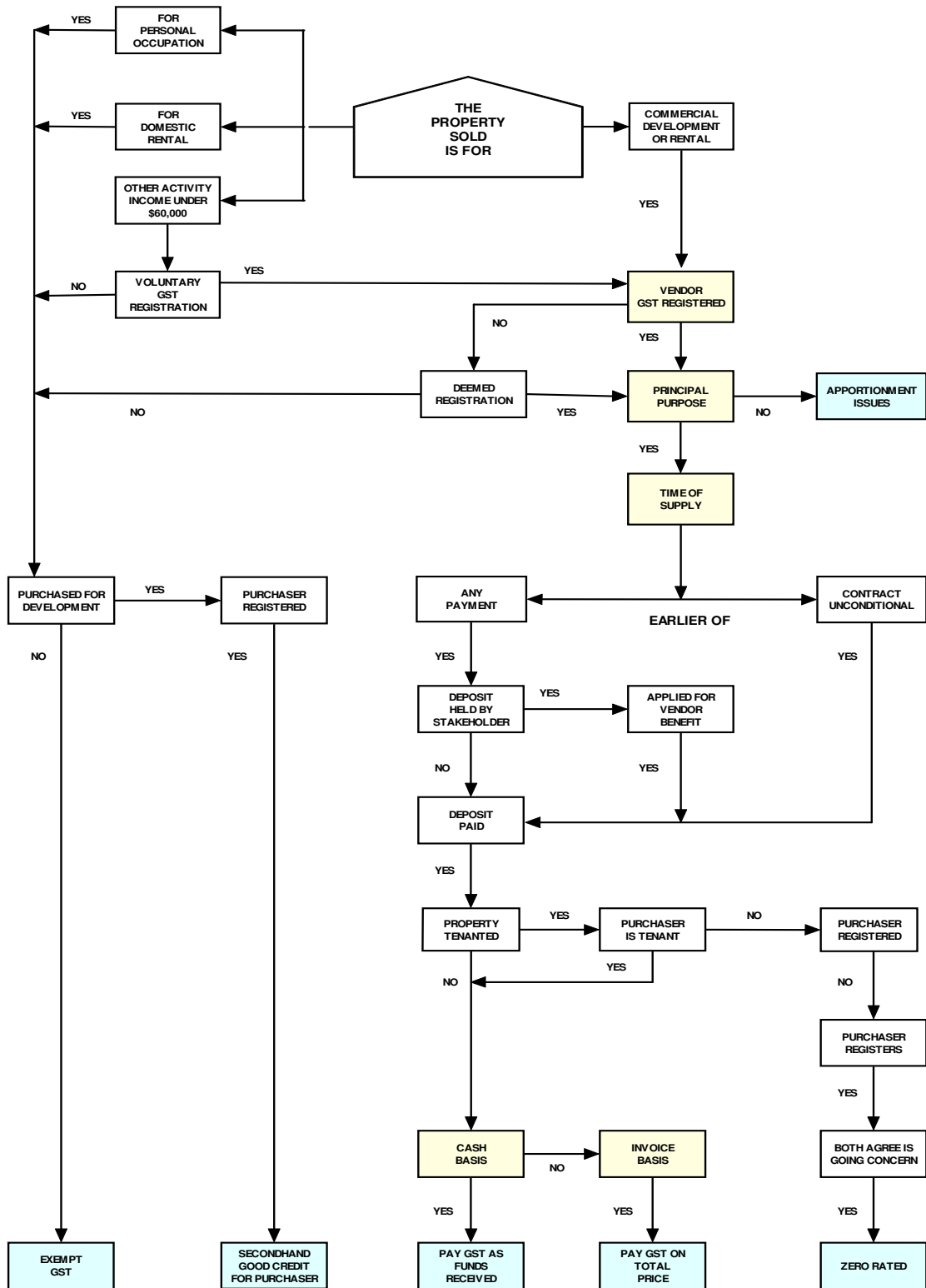
- whether or not an activity is taxable depends on the facts of each case;
- the creation of two sections not involving development work will not by itself be taxable;
- whether or not the activity is continuous and is therefore taxable depends upon the facts of each case. This involves consideration of:
  - the scale of the subdivision
  - the amount of development work
  - the time and effort involved
  - the amount of the financial investment
  - the commerciality of the transaction
- the one off sale of other private assets will not in isolation constitute a taxable activity.

Thus the policy is no more helpful in defining where the boundary line between a continuous and a non-continuous activity is located.

On payment of a fee to IRD, it is possible to obtain a binding ruling on the particular circumstances.

For income tax purposes a subdivision includes a cross leasing or conversion to unit titles.

## GST ON A REAL ESTATE TRANSACTION



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