BRANDT SEGEDIN LP
TAXATION SPECIALISTS

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Dear Garreth

You have asked us to provide tax advice in relation to various transactions that can occur between developers (land & build packages) and their customers.

Issue One

Where a deposit is not refunded to the customer/client due to the developer being liquidated and the property is being built on “capital account” ie as a rental, can a bad debt be claimed for income tax?

Response

No, where the purpose of acquiring the property is not for either resale or as part of a dealing business the property is no different to the purchase of any other capital asset and the loss of the deposit is a non deductible capital loss.

Issue Two

In some situations the contract between the customer/client and the developer include a provision where the developer must reimburse interest costs incurred on the building during the build costs. At times these are paid by way of a credit from the developer to the customer’s bank account, and other times they are deducted from a progress payment to the developer. Could these be viewed as a loan of sorts to the developer (seeing as they are legally obliged to reimburse the client) and therefore qualify as bad debts?

Response

A loan involves the advance of either cash or non cash consideration by one party to another in return for a promise to repay in the future. Loans are financial arrangements for income tax purposes. A loss of principle on a financial arrangement will only be deductible if the lender is in the business of money lending.

In this case, the customer/client has not lent the developer cash or transferred any other form of consideration to the developer. The customer is being reimbursed on the basis of costs linked to the contract for the building of the house. Even if this were a loan the loss would not be deductible under the financial arrangement rules.

Issue Three

In some situations the contracts also specify that the developer will pay a rental top-up of $50/week for the first 12 months. Could this be written off as a bad debt?

Response

This transaction is not a loan as the customer has not advanced funds to the developer. There is no loan and therefore no loss/bad debt relating to a loan. Further the customer/client may not actually have lost any money rather they have lost the prospect of receiving money in the future. This is not a loss that is deductible for tax purposes. A revenue bad debt cancels any amount already returned for income tax purposes, that the debtor later fails to pay. If the customer/client has already returned the top-up rent this could be claimable as a bad debt.

Issue Four

Some contracts specify that the deposit paid to the developer is for designs, engineering and council consent. As being able to build a house is by no means guaranteed due to the fact that consent may not be obtainable, does this change the deductibility of the costs in the above-mentioned scenario?

Response

The fact that the deposit is not refundable in certain circumstances, does not alter the answer in any of the above scenarios. There is a recognised tax principle that just because an outlay is unsuccessful it does not change the nature of the expenditure nor influence whether the expenditure is revenue or capital.

Issue Five

In view of significant rises in the Auckland property market, could the customer/client decide by way of company resolution (most have purchased the investment property using an LTC) that the project shall now be sold at some stage, with the intention of making a profit which will be subject to capital tax on the gain, ie, that it shall be viewed as a “revenue” investment and not a “capital” investment? As an incidental effect of this decision, then in the above scenario would this mean that deposits and progress payments could therefore be written off as bad debts? Or could this run the risk of being viewed as tax avoidance?

Response

In this situation, the assumption is these customers/clients are not dealers/developers or associated to dealers/developers. If that is the case the property would only be subject to income tax if it was purchased with the intention of resale (section CB 6). The intention of resale must exist at the time of acquisition. If a profit is taxable under this provision a loss will be deductible.

For this provision to apply there must be a crystallised intention of resale at the time of acquisition. The time of acquisition has been subject to recent legislative clarification and the following commentary outlines the application of this:

Indicative characteristics of the date a binding agreement is entered into (that is, the agreement has no conditions precedent, but the vendor and the purchaser intend to be bound by the terms of the contract even if there are conditions subsequent that have to be fulfilled) are:

• *the date a binding sale and purchase agreement has been signed and executed by both the vendor or purchaser (including nominees or agents); or*

• *the "Date" indicated on a binding sale and purchase agreement, which is then subsequently signed by the parties to the agreement; or*

• *the date a binding oral agreement for the disposal of land was agreed to by the parties, which has then been subsequently actioned by part performance of the agreement and if required later, evidenced by a memorandum.*

Therefore for the loss to be claimable under section CB 6 the intention of resale should have existed at the latest when the agreement that was executed was originally dated. The onus of proof in relation to the intention existing at that date is on the client/customer. In cases involving intention of resale the IRD will explore all sources of third party information including bank diary notes, conversations with mortgage brokers real estate agents etc.

Any attempt by the customer/client to falsely claim there was an intention of resale at the time of acquisition is likely to be unsuccessful and would be considered seriously by IRD under the provisions relating to tax evasion.

Yours faithfully

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