

TECHNICAL DECISION SUMMARY > PRIVATE RULING

WHAKARĀPOPOTO WHAKATAU HANGARAU > WHAKATAUNGA
TŪMATAITI

Sale of leasehold interests in residential and commercial units

Decision date | Rā o te Whakatau: 3 September 2024

Issue date | Rā Tuku: 23 January 2025

TDS 25/01

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Subjects | Kaupapa

Income tax: PIE rules; assets and income derived from development; whether still within the rules for a PIE

Taxation laws | Ture tāke

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

Summary of facts | Whakarāpopoto o Meka

1. A was a registered New Zealand limited partnership.
2. The majority limited partner of A was B Ltd. B Ltd was an incorporated company that was registered as a multi-rate portfolio investment entity (PIE).
3. A leased land from an unrelated third party and developed a number of apartments and commercial units (units) on the land under the Unit Titles Act 2010 (UTA). A sold the units to members of the public by first granting itself a sublease of each unit and then assigning the sublease to the purchaser (resident).
4. The Arrangement was the sale and purchase of strata estate in leasehold interests entered into between A and prospective residents of units, as well as commercial tenants.
5. Under the terms of the sale and purchase agreement, a portion of the purchase price (referred to as "Entry Rent") paid by a resident was allocated as consideration for the assignment of the sublease which A granted to itself with the effect that the resident became the new lessee under the sublease with A remaining as lessor.
6. In addition, an amount (referred to as "Exit Rent") is paid by a resident to A on disposal of their leasehold interest in the unit to a new purchaser. The Exit Rent was described in the lease agreement as being a contribution to the Landlord's general costs incurred in the supply of the use of the Unit and common facilities. The Exit Rent did not include ground lease payments.

Issues | Take

7. The main issues considered in this ruling were whether:
 - the assets, as listed below, fell within the permitted asset holdings for a PIE:

- Ground lease interest in land
- Strata leasehold estate in units prior to sale
- Leasehold interest in infrastructure, common area buildings and or commercial units (subleased to third parties who were not associated).
- the income, as listed below, fell within the permitted income categories for a PIE.
 - Sale proceeds derived from the sale of strata leasehold interests in the units
 - Rent derived from residential occupants including Entry Rent and Exit Rent
 - Sale proceeds derived from the sale of strata leasehold interests in any commercial units
 - Rent derived from any commercial tenants.

Decisions | Whakataurua

8. The Tax Counsel Office (TCO) concluded:
- the investments, as listed below, were permitted investment types under s HM 11(1)(a):
 - Ground lease interest in land;
 - Strata leasehold estate in units prior to sale;
 - Leasehold interest in infrastructure and commercial units but excluding any property that was “common property” as defined in s 5 of the Unit Titles Act 2010 and owned by the body corporate under s 54 of that Act.
 - the income, as listed below, met the criteria in s HM 12(1)(b), provided that the lessee under a lease was not associated with A or B Ltd under subpart YB:
 - Rent derived from residential occupants, including the Entry Rent and Exit Rent;
 - Rent derived from any commercial tenants
 - Sale proceeds derived from the sale of strata leasehold interests in the residential units;
 - Sale proceeds derived from the sale of strata leasehold interests in any commercial units.

Reasons for decisions | Pūnga o ngā whakatau

Issue 1 | Take tuatahi: PIE income and asset requirements

9. Section HM 7 sets out the requirements that a PIE must meet and maintain for PIE status. In summary, a PIE must maintain the requirements in ss HM 8 to HM 20. The only provisions considered by TCO were ss HM 11 and HM 12.

PIE investment types under s HM 11

10. Under s HM 11, an entity's investments must, to the extent of 90% or more by value of its assets, be one of the types of investments listed below:
- An interest in land:
 - A financial arrangement:
 - An excepted financial arrangement:
 - A right or option in relation to property listed above.
11. B Ltd had a majority share of the interests in A and A held the relevant assets relating to the Arrangement.
12. Under s HG 2(1)(b), a partner is treated as holding property that a partnership holds, in proportion to the partner's partnership share, and the partnership is treated as not holding the property. Therefore, in considering the investments held by B Ltd for the purposes of s HM 11, it was necessary to look through to the investments held by A.
13. TCO ascertained that B Ltd would be treated as holding the following interests of A :
- A ground lease interest in land as lessee;
 - Strata estate in leasehold in the units constructed prior to their sale to residents;
 - A leasehold interest in infrastructure, common area buildings and commercial buildings/units (to be subleased to un-associated third parties).
14. TCO concluded that the ground lease interest, the strata leasehold estate in units and the leasehold interest in infrastructure and commercial units (but excluding any property that was "common property" as defined in s 5 of the UTA and owned by the body corporate under s 54 of UTA) was an interest in land under s HM 11. Section YA 1 defined "an interest in land" as an estate or interest in land and included a right to possession of the land, such as a licence to occupy.

15. Therefore, the leasehold interests were “interests in land” as they were estates in land. Accordingly, A had an “interest in land” under s HM 11(1)(a) in relation to the ground lease, the strata leasehold estate and the interests in infrastructure and commercial units (subject to the exclusion in [15]) which B Ltd was treated as holding under s HG 2.

Income types under s HM 12

16. Under s HM 12 income derived by an entity that wishes to satisfy the PIE requirements must, to the extent of 90% or more:
- be derived from property referred to in s HM 11; and
 - consist of one of the following types of income:
 - a dividend (s HM 12(1)(b)(i));
 - a replacement payment (s HM 12(1)(b)(ii));
 - an amount under subpart EW treated as derived by the entity (s HM 12(1)(b)(iii));
 - an amount derived from a lease of land (unless the lessee is associated with the entity) (s HM 12(1)(b)(iv));
 - insurance, indemnity, or compensation amounts replacing an amount derived from a lease of land (s HM 12(1)(b)(ivb));
 - an amount derived from the disposal of property referred to in s HM 11 (s HM 12(1)(b)(v));
 - FIF income (s HM 12(1)(b)(vi));
 - attributed PIE income (s HM 12(1)(b)(vii));
 - a distribution from a superannuation fund (s HM 12(1)(b)(viii));
 - an amount of income under ss CW 4 or CX 40 (s HM 12(1)(b)(ix));
 - a rebate on a management fee (s HM 12(1)(b)(x)).
17. TCO ascertained that the following types of income would be derived by B Ltd:
- Sale proceeds derived from the sale of strata estate in leasehold interests in the units.
 - Rent derived from residential occupants, including the Entry Rent and the Exit Rent.
 - Sale proceeds derived from the sale of strata estate in leasehold interests in any commercial units.

- Rent derived from any commercial tenants.

Sales proceeds derived from the sale of the strata estate in leasehold interests in the units

18. TCO concluded that the sale proceeds derived from the sale of strata leasehold interests in the residential and commercial units was qualifying income under s HM 12 as these amounts were income derived from a lease of land under s HM 12(1)(b)(iv). While B Ltd derived income from the sale of the strata estate in leasehold interests in the Units to residents, the nature of the leasehold interests provided to residents meant that the residents were effectively leasing the units from A per the terms of the lease agreements that residents had to enter into with A alongside acquiring their leasehold interest. Accordingly, TCO considered that the land had been developed by A primarily for lease and that the sale proceeds were best characterised as amounts derived from a lease of land.
19. Section HM 12 is concerned with the income a PIE derives, which will be taxed under the PIE regime. For a partner in a partnership, that income will include their share of the income derived by the partnership. Therefore, TCO considered that s HG 2 was directly relevant and must be applied in the context of determining the nature of the income that was derived by an entity for the purposes of s HM 12.
20. Under s HG 2, B Ltd would be treated as carrying on the activities of A for the purposes of s HM 12. TCO noted that the Arrangement had some similarities with commercial property owned by listed property PIEs, where development of land and buildings may be undertaken to lease to tenants.
21. Alternatively, TCO considered the sale proceeds derived by B Ltd from the strata estate leasehold interests in the units would satisfy s HM 12(1)(b)(v) as they would be an amount derived from the disposal of property referred to in s HM 11. Importantly, TCO concluded that the sale proceeds were not derived from the development of land.

Entry Rent

22. TCO considered that the following principles applied in interpreting the phrase "derived from a lease" contained in s HM 12(1)(b)(iv):
 - Whether the amount is flowing, springing or emanating from a lease;
 - It does not matter whether the payment is stipulated in the lease itself or in a separate agreement;
 - There must be some real nexus between the grant of the lease and the payment;

- In determining the nexus between the payment made to acquire something (for instance, a good or service), and the lease, consideration should be given to the nature of the business carried on by the lessee, the particular site on which the business is carried on, and the connection between what was acquired and the leased site;
 - The enjoyment of occupation under the lease must be essential or inseparable from what was obtained as a result of the payment.
23. Therefore, as the wording of s HM 12 only required that an amount of income was derived from a lease of land, TCO considered this was broad enough to cover the Entry Rent as it was paid by a resident in return for becoming the lessee under the sublease issued by A. There was a real nexus between the grant of the sublease and the payment of the Entry Rent as it was paid by a resident for the accompanying sublease to their leasehold interest. As a result of the payment of the Entry Rent (along with the Purchase Price), the resident became a lessee and was entitled to occupy their unit and use the common areas and facilities per the lease agreement.

Exit Rent

24. TCO considered that the Exit Rent appeared to be a payment of deferred rent under the lease as it related to the resident's occupation of their unit and their use of associated services and amenities (excluding amounts that were charged as monthly Outgoings). Therefore, it was necessary to consider whether this was an amount of income derived from a lease of land by A (the Exit Rent was arguably not an amount derived on disposal of an interest in land as it was derived by A rather than the resident selling the leasehold interest in their unit).
25. It was TCO's view that any additional maintenance, services and amenities provided to residents as part of their accommodation that was covered by the Exit Rent was directly connected to the resident's enjoyment of their unit under their lease. This was because the lease related not only to the unit but also to the right to use and enjoy the common areas as a whole, in conjunction with the other residents. This view was conditional on the lessee not being associated with B Ltd or A.

Sale of leasehold interests to commercial owners and rent derived from commercial third party operators

26. TCO considered that the same analysis outlined above in relation to the sale of leasehold interests in the residential units applied so that the sales proceeds were income under s HM 12(1)(b)(iv) as income derived from a lease of land.

27. In relation to rent derived by B Ltd from commercial businesses, this was clearly income derived from a lease of land under s HM 12(1)(b)(iv).

Conclusion on s HM 12

28. TCO concluded that sale proceeds derived from the sale of strata leasehold interests in the residential and commercial units was qualifying income under s HM 12 as these amounts were income derived from a lease of land under s HM 12(1)(b)(iv) or alternatively were income from the disposal of an interest in land under s HM 12(1)(b)(v).
29. TCO also concluded that the Entry Rent and the Exit Rent were income under s HM 12(1)(b)(iv) as income derived from a lease of land. It was further concluded that rent derived from any commercial tenants was also income under s HM 12(1)(b)(iv). TCO noted that s HM 12(1)(b)(iv) did not apply if the lessee under a lease was associated with the entity receiving the amount.