

ASSOCIATED PERSONS – WHY BE ONE?

On 2 July 2008, the main tax bill for this year was introduced into the House. While using the phrase “eagerly anticipated” gives a misleading impression of how tax practitioners look at the world, there was certainly curiosity about what shape the reform of the associated persons rules would take. In particular, practitioners and their clients will be eager to learn the extent to which the officials’ paper of March 2007¹ will be given legislative effect.

BACKGROUND

The Income Tax Act 2007 (“the Act”) introduced a new format for defining associated persons, placing the focus on the nature of the relationship rather than the context of the application of the rules. With the introduction of the Taxation (International Taxation, Life Insurance, and Remedial Matters) Bill (“the Bill”), sections YB 1 to YB 20 of the Act have been completely replaced by new provisions which, in general, enact the bulk of last year’s recommendations. In one respect, the new provisions makes the reading of subpart YB somewhat easier, in that it applies for the purposes of the whole Act unless a section expressly states otherwise. The references to 1973, 1988 and 1990 version provisions will be removed.

The changes will have a profound effect, particularly on property developers – which is one of the main reasons for the changes. The commentary to the Bill explains that “major weaknesses” were seen in the current legislation, particularly as it relates to land sales.² It notes that when the current form of the associated persons rules was introduced in 1973, it was Parliament’s intention that any land acquired by a land dealer should be subject to tax upon sale – either because it was acquired as part of the land dealing business or, if it was not, if it was sold within 10 years of acquisition. The then Minister of Finance, Bill Rowling, is quoted:

“Profits and gains from real property will now be assessed when...the property was acquired by a land dealer and either was held as part of his land dealing business and later sold – in which case the profits will be assessable irrespective of the period between acquisition and sale – or, if it was not held as part of his land dealing business but is sold within ten years of acquisition, for example, claimed to be held as an investment but sold within this ten-year period.”

During the years since, perceived “loopholes” have circumvented Parliament’s intention giving rise to the need for reform.

¹ “Reforming the Definitions of Associated Persons”, Policy Advice Division of the Inland Revenue and the New Zealand Treasury (March 2007).

² See page 79 of the Commentary.

In the time that has passed since 1973, many of these “loopholes” have simply become common practice. Structures, often using trusts, have been established to enable property dealers to hold genuine investment property without fear of that property being tainted by association with their development activities. Taxpayers have been able to ensure they put the right eggs in the right basket. Over time, a certain perception of fairness about that has developed. While it must be accepted that there may be questions about how genuine an “investment” may be, the same can be said for any person who chooses to invest in property.

CONTEXT FOR PROPERTY DEVELOPERS

The Act contains specific provisions for imposing tax on people involved in a business related to land. In particular, if a person is in the business of dealing in land, developing or subdividing land or building, they will be taxed on the proceeds from the sale of land acquired for the purposes of that business, and otherwise if the land is sold within 10 years of acquisition. In the case of builders, the relevant time is within 10 years of the completion of improvements. Further, a person who is associated with such a person will also be taxed on proceeds from land sold within 10 years of acquisition.³

NEW ASSOCIATED PERSONS RULES

We now review the new associated persons tests and their application, with particular emphasis on their effect on land transactions. Unless otherwise noted, references in this paper are to the proposed new sections promulgated in clause 414 of the Bill.

Two companies – section YB 2

The association test is mainly unchanged, referring to two companies with 50% or greater total voting interests in common. Under the current Act, a natural person is treated as holding anything held by a relative, although this does not apply for the purposes of land transactions. Under the Bill, that limitation no longer applies. Section YB 2(4) imposes an aggregation rule in that person A is treated as holding anything held by person B if A and B are associated under the associated persons rules.

A company and a person other than a company – section YB 3

A company and a person other than a company will be associated where the person has a 25% or more voting interest in, or control over, the company. An aggregation rule ensures that a person who is associated with another person under any of the following sections is treated as holding that other person’s interest in the company.

³ See sections CB 7, 9, 10 and 12 of the Act.

Separate rules are provided for the purposes of the land provisions. These broadly reflect the current provisions, in that a company and a person will be associated if 25% or more of the company is controlled by: the person; the person's spouse or partner; the person's infant child; a trustee of a trust under which the person, their spouse or partner or infant child has benefited or is eligible to benefit; or any combination of such persons. It has also been clarified that, in this context, a "person other than a company" includes a corporate trustee.

Relatives - section YB 4

Generally, relatives to the second degree will be associated. This represents a concession compared with the current Act, where association is generally to the fourth degree, which has long been considered too wide a test. For example, a person will no longer be associated with their cousin.

For the purposes of the land provisions, the association through being a relative is restricted to marriage (including civil union and de facto relationships) and infant children.

Person and trustee for relative – section YB 5

There is no change to the current rules, in that a person is associated with the trustee of a trust under which a relative of the person is associated (as per the rules in section YB 4, above).

Trustee and beneficiary – section YB 6

A trustee and a beneficiary will be associated for all purposes under the Act, except for the land provisions.

Two trustees with common settlor – section YB 7

Previously, this only applied in respect of the international tax rules (with certain exceptions), petroleum mining and miscellaneous rules. However, the Bill proposes that this test now be applied for the purposes of the entire Act.

The use of trusts has been one way whereby property developers have been able to legitimately separate development and investment activities. Traditionally, it has been difficult to associate trusts. The Bill will make most trust structures associated.

Trustee and settlor – section YB 8

As with the common settlor provision, the association of trustee and settlor now applies for the purposes of the entire Act, including the land provisions. Previously it only generally applied to the international tax rules. Under this section, a trustee of a trust will be associated with the settlor of the trust.

Settlor and beneficiary – section YB 9

In a new provision, a settlor and a beneficiary of a trust will be associated. However, this does not apply for the purposes of the land provisions.

In the context of this section, and sections YB 7 and YB 8, “settlor” has the meaning set out in section HC 27 (which, generally, refers to persons who have transferred value to a trust, including the provision of financial assistance) but does not include a person who provides services to a trust for less than market value.

Trustee and person with a power of appointment or removal – section YB 11

A trustee of a trust will be associated with a person who has the power to appoint or remove trustees from that trust. In practice, this is unlikely to expand the provision in section YB 8, as the power of appointment is typically conferred on the same persons who are settlors of a trust.

Partners – sections YB 12 and 13

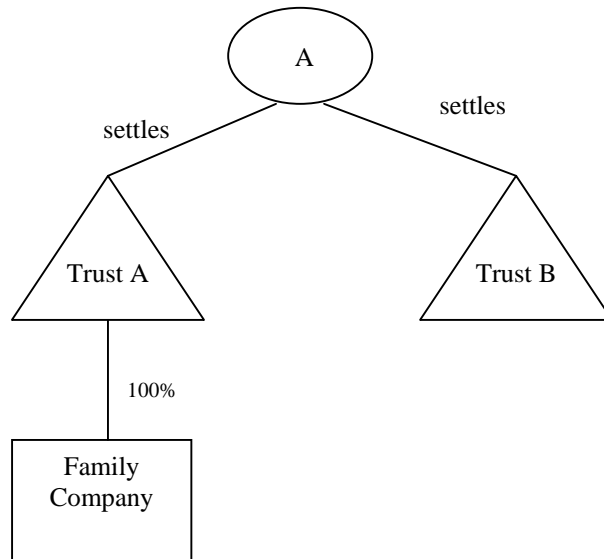
As per the current rules, under the Bill a partnership and a partner are associated, as is a partnership and a person associated with a partner (one of the limited existing tripartite tests).

An adjustment has been made for limited partners, so that they are not associated with a limited partnership unless they have a 25% or greater interest. This creates symmetry with the provisions between a company and a person other than a company.

The tripartite test – section YB 14

What was probably the most dreaded part of the officials March 2007 paper has been retained and included in the Bill – with limitations.

Put simply, if A is associated with B and B is associated with C, then A will be associated with C. This provision in particular will put an end to many current structures used to separate land dealing businesses from investment activities. An example is provided in the Commentary to the Bill:



Under the current rules, the following associations are in effect:

- (a) Trust A is associated with Family Company, because Trust A controls more than 25% of the company (current section YB 5).
- (b) Settlor A is associated with both Trust A and Trust B because a settlor is associated with the trustee of the trust – but generally only for the purposes of the international tax rules (current section YB 15).
- (c) Trust A is associated with Trust B because they have a common settlor. However this does not currently apply for the purposes of the land provisions (current section YB 14).

Of note is the fact that, under the current rules, the family company is not associated with Trust B. The family company would be able to carry on a property development business while Trust B could hold investment properties without those properties being tainted.

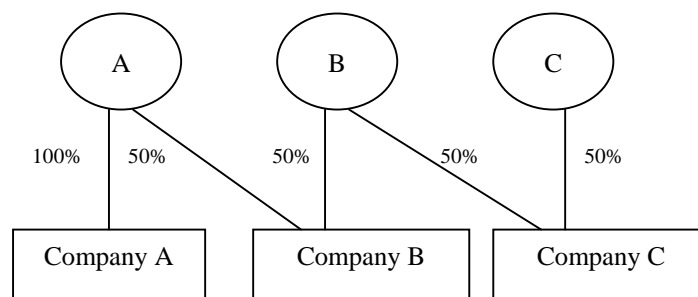
Under the new association rules provided in the Bill, the associations set out above are expanded.

- (a) Trust A and the family company remain associated (new section YB 3).
- (b) Settlor A will be associated with both trusts – but for all purposes under the Act, including the land provisions (new section YB 8).
- (c) Trust A and Trust B will be associated – again, for all purposes under the Act (new section YB 7).
- (d) The family company will be associated with Trust B under the tripartite test. The association arises because both the family company and Trust B have Trust A as an associate in common.

There are limitations to the application of the tripartite test. It is comforting to know that officials are concerned to ensure that “the test does not apply more widely than is necessary to protect the tax base”.⁴ The tripartite test will not apply if two persons are each associated, under the same test, with the same third person under the rules associating:

- (a) two companies (section YB 2);
- (b) a company and a person other than a company (section YB 3);
- (c) two relatives (section YB 4);
- (d) a partner and a partnership (section YB 12); and
- (e) a partnership and an associate of a partner (section YB 13).

An example in the Commentary to the Bill illustrates the application of the limitation of the tripartite test.



Company A is associated with Company B under section YB 2 because Person A controls 50% of both companies. The same applies to Companies B and C in respect of Person B controlling 50% of both of those companies. Without the limitation, Companies A and C would be associated by the tripartite test despite the fact that they have no shareholding in common at all.

OTHER ASSOCIATED PERSONS CHANGES

The test as to whether a dividend arises has been amended. At present, the general test defining a dividend, contained in current sections CD 4 and CD 6, refer to a transfer of value arising because of a shareholding relationship; such a relationship is specifically defined to include the holding of shares either by the recipient or a person associated with the recipient. The Bill proposes to change that by defining a dividend as a transfer of value where “the cause of the transfer is a shareholding in the company, whether or not the (recipient) holds shares in the company.”⁵ It remains to be seen how the removal of defined parameters will work in practice.

A similar approach has been taken to the provision of fringe benefits. FBT currently applies where benefits are provided to an employee or a person

⁴ Commentary to the Bill, p 88.

⁵ Clauses 10 and 11 of the Bill (amending sections CD 4 and CD 6).

associated with an employee. Section GB 32 is to be amended so that FBT applies where “the benefit is provided to a person because of the existence of an employment relationship”.⁶ Again, it remains to be seen how the removal of defined parameters will work in practice.

There are numerous other references to associated persons scattered throughout the Income Tax Act. The new rules mean that the variety in their application can be rationalised. For example, in the attribution of personal services income rules⁷, reference is made to associated persons, which then requires a somewhat convoluted definition that is now able to be greatly refined.

APPLICATION

The proposed application date of the new associated persons rules is 1 April 2009. For the purposes of the land provisions, the new provisions only apply in respect of land acquired on or after 1 April 2009 (or for builders, where improvements are commenced on or after that date).

CONCLUSION

Bill Rowling may have passed away but his legacy lives on. The new associated persons rules will significantly broaden the application of the Income Tax Act. Property developers who also wish to enjoy tax free capital gains on investment properties will find it much harder, if not impossible, to implement structures whereby they are able to derive such tax free gains yet still retain any degree of control.

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⁶ Clause 183 of the Bill.

⁷ Sections GB 27 and 28 ITA 2007.