



Willy Sussman Partner

New “associated persons” test unworkable

Inland Revenue has released a discussion document proposing changes to the income tax definition of “associated persons”.

These changes are driven by perceived “loopholes” in the current rules, particularly as they relate to gains on the sale of land. We think that the proposed changes are not the right response to this perceived problem.

Submissions on the proposed changes close on 11 May and if these proposals become law it would be prudent to assume you are associated to a developer unless you can prove otherwise.

In this update we provide a series of examples showing the breadth of the proposed rules that result in essentially unworkable outcomes.

But first, a quick recap on some of the consequences of being “associated persons”:

- Where a person is associated with a developer or land dealer at the time they acquire land, gains on the sale of that land, will, if sold within 10 years of acquisition give rise to taxable income.
- Various transfers of property between associated persons are deemed to occur at market value.

- The transfer of value between a company and an associate of its shareholder will be a dividend for tax purposes.
- The Income Tax Act definition of “associated persons” is used in other legislation and in commercial transactions – for example restraint of trade provisions.

So who will be associated?

Each example considers whether Bob, who acquires a rental property, is associated to a developer or dealer. Bob did not acquire his rental property for the purpose of resale. As it happens though, Bob sells the rental property six years after he bought it. If Bob was associated with a developer when he acquired the property then the gain on the sale of the property would be taxable.

The scenarios build on each other to show just how wide the test will become.

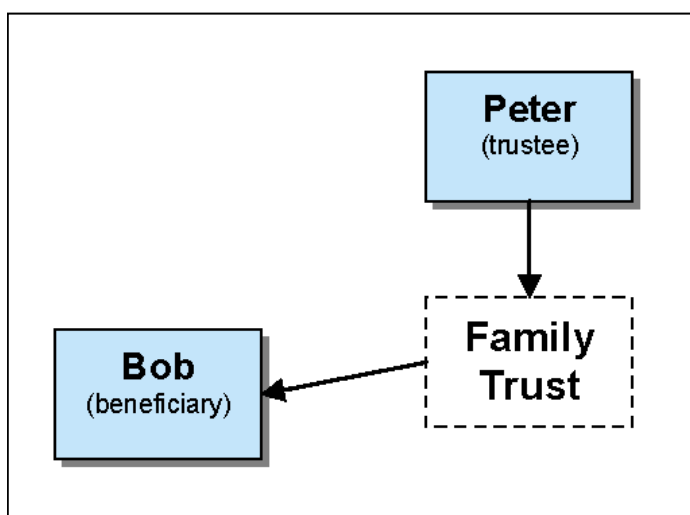
Trustees and people eligible to benefit under family trusts

The new rules will associate the trustee of a trust with a person eligible to benefit under that trust. This is a significant extension, particularly in light of the fact that there are in excess of 300,000 family trusts in New Zealand, and many will have a very wide category of discretionary beneficiary.

It is common for family trusts to include cousins, uncles, aunts, nephews and nieces as potential beneficiaries.

So, let's say that Bob's Uncle Peter is a property developer and is a trustee of his family trust that includes his nephews as potential beneficiaries. Under the new rules, Bob will be associated with Uncle Peter. Bob will therefore have to pay tax on the gain he makes on selling his rental property.

The fact that Bob may be unaware that Uncle Peter has a family trust, or that he is eligible to benefit under that trust makes no difference.



Settlers and people eligible to benefit under family trusts

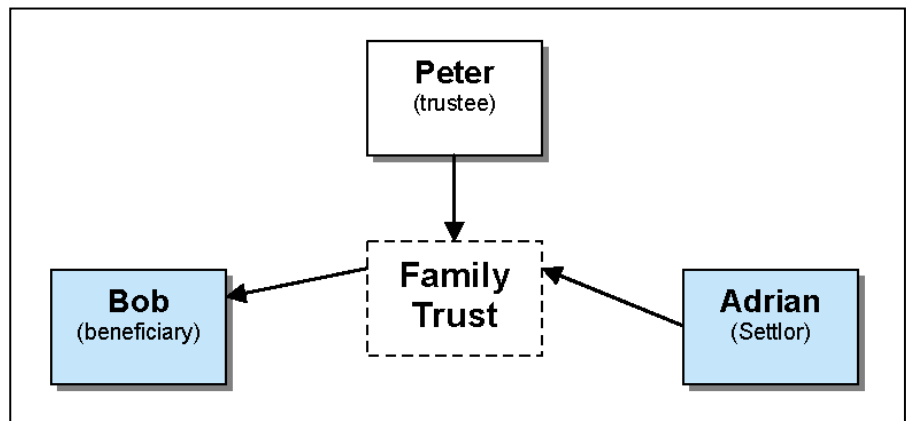
In addition to associating trustees and beneficiaries, the new rules will also associate the settlor of a trust with people eligible to benefit under that trust. So, for example, if Uncle Peter simply settled a trust, rather than being a trustee, Bob would still be associated with him.

The concept of "settlor" is very wide under the tax legislation and includes anyone who provides goods or services to the trust for less than their market value. So, let's say that Uncle Peter's mate, Adrian, is a builder and property developer and Adrian does some building work on Peter's home (owned by the family trust) and does not charge for his labour, and so becomes a settlor of Peter's trust.



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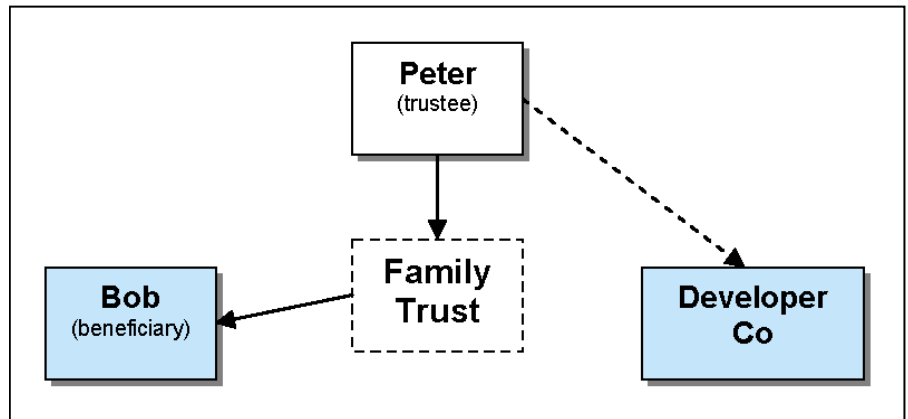
Bob is therefore associated with Adrian. As Adrian is a property developer, Bob is taxable on the gain from the sale of his rental property.



Universal tripartite test

Inland Revenue’s discussion document proposes introducing a “universal tripartite test”. Although this may sound like something from Star Trek, it in fact means that if A is associated with B, and C is also associated with B; then A and C are associated.

So, let’s say that Peter has a 30% interest in a property development company (Developer Co). Peter is associated with Developer Co because his shareholding exceeds 25%. Bob is associated with Peter through the trustee/beneficiary test, so Bob is associated with Developer Co.



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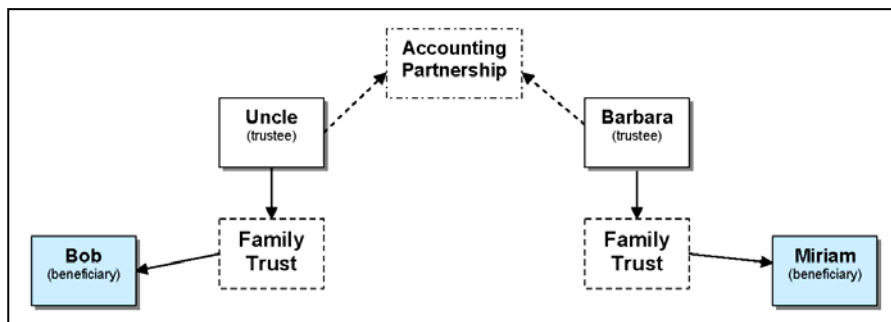
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Partnerships

Under existing rules, an associate of a partner is associated with the partner's partnership. Combining this with the universal tripartite test produces some quite spectacular results!

Let's say that Peter is a partner in an accounting practice. One of his partners, Barbara, has established her own family trust. Barbara's cousin Miriam is eligible to benefit under Barbara's family trust. Miriam is a property developer.

Bob is associated with his uncle Peter, and is therefore associated with Peter's accounting partnership. Miriam is associated with Barbara (as a beneficiary under a trust settled by Barbara) and Miriam is therefore associated with the accounting partnership. As both Bob and Miriam are associated with the accounting partnership, under the universal tripartite test they are associated with each other!



One step too far?

The proposed tests are too wide. It will be impossible to prove that you are not associated with a developer at the time of acquiring land. It is significant that the lack of knowledge about the existence of a trust or eligibility to benefit under a trust will not be a defence to being associated.

As a final example, let's say that a property developer has established a trust, primarily for his family's benefit but includes as discretionary beneficiaries any IRD employee.

As a result of the proposed rules, every Inland Revenue employee would be taxable on the proceeds of any rental property sold within 10 years of its acquisition! Certainly a step too far.

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