

TAX

ASSOCIATED PERSONS REFORM

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Daniel Hicks  
SOLICITOR

Legislation introduced in July has proposed significant reform of the associated persons regime in the Income Tax Act 2007. The associated persons rules generally operate as an anti-avoidance measure and are commonly used to either impute a certain status to a taxpayer or to enforce the use of market values in non-arm's length dealings.

**Why the rules are being amended**

The government perceives that the current rules are ineffective and changes are being proposed primarily to ensure that taxpayers cannot avoid association through the use of multiple trusts or companies. Many of the proposed changes aim to catch people (including companies, partnerships and trusts) who separate off certain activities to avoid "tainting" other business activities with an unfavourable tax status.

**A broad new associated persons test**

The government's initial proposal made the tests of association extremely wide and met with extensive criticism, especially in relation to the "tainting" of taxpayers as land dealers or developers. For situations not involving land sales, the new rules remain very broad and may affect taxpayers in the application of a range of tax regimes

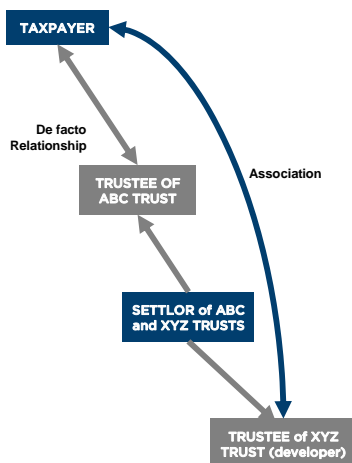
(including the approved issuer levy regime, the transfer pricing regime and the thin capitalisation regime).

**Land-related transactions**

Following the criticism of the original proposals, significant concessions have been made in relation to the land provisions. However, the introduction of aggregation and tripartite tests will still operate to widen the number of people a taxpayer will be associated with. This may result in taxpayers being associated with people they are unaware of. For example, under the proposed rules a taxpayer will be associated with the XYZ Trust in the scenario illustrated to the left.

The taxpayer is associated to the XYZ Trust via his de facto relationship with the trustee of the ABC Trust, which happens to have the same settlor as the otherwise unrelated XYZ Trust. Alternatively, if the taxpayer had no relationship with the trustee of the ABC Trust, but made some form of settlement on the ABC Trust, he would again be associated with XYZ Trust.

In either of these circumstances, if the XYZ Trust happens to engage in land development activities, the taxpayer will be tainted with land developer status and certain capital gains on real property sales will be subject to tax. This is the case even



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For further information, please contact your usual Bell Gully adviser or:

**Niels Campbell**  
64 9 916 8944  
[niels.campbell@bellgully.com](mailto:niels.campbell@bellgully.com)

**David Simcock**  
64 9 916 8945  
[david.simcock@bellgully.com](mailto:david.simcock@bellgully.com)

**Willy Sussman**  
64 9 916 8952  
[willy.sussman@bellgully.com](mailto:willy.sussman@bellgully.com)

**John Bassett**  
64 9 916 8946  
[john.bassett@bellgully.com](mailto:john.bassett@bellgully.com)

**Mathew McKay**  
64 9 916 8329  
[mathew.mckay@bellgully.com](mailto:mathew.mckay@bellgully.com)

**Graeme Olding**  
64 9 916 8792  
[graeme.olding@bellgully.com](mailto:graeme.olding@bellgully.com)

**Daniel Hicks**  
64 9 916 8397  
[daniel.hicks@bellgully.com](mailto:daniel.hicks@bellgully.com)

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if the taxpayer holds the real property on capital account, is not a developer in his own right and is unaware that the XYZ Trust exists. As this example demonstrates, the proposed tests of association may be far reaching and inadvertently becoming associated with another person may have a significant impact on a person's tax liability.

## Summary of the proposed rules

The proposed new tests fall into a number of categories and create association between companies, trusts, partnerships and natural persons.

Two companies will be associated where the same group of people control both companies or hold 50 percent or greater voting interests in both companies. A company and a person will be associated where the person has a 25 percent or greater voting interest in the company. It should be noted that the interests of certain associates are aggregated when applying these tests. Relatives within two degrees of relationship will be associated, as will a person and their spouse, civil union partner or de facto partner.

For the purposes of the land provisions, the association between relatives is restricted to a taxpayer's spouse, civil union partner or de facto partner and the taxpayer's infant children.

Trust-related tests associate a person and a trustee for a relative, a trustee and a beneficiary, two trustees with a common settlor, a trustee and a settlor, a settlor and a beneficiary and a trustee and a person with a power of appointment. For the purposes of "tainting" taxpayers with dealer or developer status, the tests that associate beneficiaries with another person do not apply.

Tests also associate partners and associates

of partners with a partnership. Limited partners (and associates of limited partners) will also be associated with a partnership where the limited partner has a 25 percent or greater partnership share.

The most significant extension of the rules is the introduction of a tripartite test which will operate to associate two people when they are associated with the same third person. This new provision will significantly broaden the application of the rules (as demonstrated in the example discussed above). There are limitations to this test but they only apply in particular circumstances.

## Application date

Other than for land-related transactions, the proposed amendments are to apply from the 2009-10 income year. Consideration should therefore be given to existing structures and arrangements which might be affected by the expanded definition of associated persons.

For the purposes of the land provisions, the reforms will apply to land acquired on or after 1 April 2009. The proposed changes should not affect the status of existing investment property or property acquired before 1 April 2009. Therefore, there is generally no need to restructure existing property holdings where that property is not affected by the existing associated persons rules.