

Client Newsletter

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Land & Associated Persons Rules

It is interesting to note how the associated persons rules have evolved since they were first enacted, in 1917, to connect two companies with substantially the same shareholders.

Since then the rules have evolved in an ad hoc manner over time into specific provisions for new tax regimes, enacted to prevent taxpayers from circumventing the tax laws. In the case of land, the associated persons rules relating to land transactions were contained in Section OD8 (4) of the Income Tax Act 2004. These have been re-written under the Income Tax Act 2007. However, the IRD released an issues paper in 2007 on reforming the rules to create one standard definition that could be applied to the whole Income Tax Act. This has not been legislated yet.

This article examines the existing associated rules without making references to any particular Income Tax Act (for the reasons stated above), highlights the defects in them and briefly states the proposed reforms.

Existing Rules

These rules were enacted in 1973 to make the 'taxation of land' reforms effective. The reforms came about because historically, land dealers, developers and builders have avoided tax on sale of land either by holding it on capital account or by having family members/related companies (who do not deal in land) hold it.

As a result, amendments were made to bring in the "10 year sale rule" and at the same time associate

family members, trust and companies to the land dealer, developer or builder.

The current definitions are specific in associating two taxpayers or persons as defined in the Tax Act. The original intention was, no doubt, based on a principle of associating two persons who do not deal with each other at arm's length. However, this is not explicit in the definitions; instead, it defines an association between:

- two companies
- two persons
- a person & a company
- a person & a partnership

In doing so, it has created loopholes even where there is an obvious association between two persons, while in other instances rendering the rules nonsensical by associating two remote persons. Let's examine this by way of examples.

1. The current associated persons rules associate a property developer (say, an individual) to their family trust if the beneficiaries are:
 - their spouse, de facto partner or civil union partner; or
 - their infant children; or
 - any trust under which the above two are eligible to benefit.

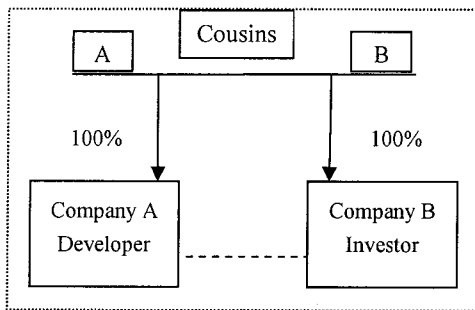
However, property developers are not associated to their family trust if the beneficiaries are:

- themselves; or
- their adult children.

This was not the intention of the rules, but it is the practical effect their application.

2. Remote association:

In the diagram below, A's company is a property development company whereas B's company is an investor. Because A & B are first cousins (i.e. their mums are sisters), company A & company B are associated under the strict application of the association rules.



Again, this was not the intention of the law but the specific rules sometimes catch two unrelated parties.

Proposed Changes

Just as these specific associated persons rules were enacted as part of the reforms in land transactions, there are other specific associated persons rules enacted for specific tax regimes. The key proposals in the issues paper are to:

- Have one standard definition of associated persons, which should apply for all income tax purposes;

- Define associated persons rules between a:
 - Trustee & beneficiary
 - Trustee & settlor
 - Two trusts with the same settlor
 - Settlor & beneficiary;
- Have a universal tri-partite test of association; and
- Restrict the definition of “relative” to only two degrees of separation so that only parents, grandparents, siblings, children and grandchildren are caught in the “relatives” net.

Having a single definition is certainly a desirable modification. But by defining an association between two persons (stated as above) in detail, the proposed rules will, potentially, also fail by not addressing the principle and purpose of the associated persons rules.

The general principle of the associated persons rules is to ensure that two parties deal with each other on an arm's length basis. This should be clearly stated in the legislation.

The main purpose of having associated persons rules is for them to function as anti-avoidance rules rather than to impose capital gains tax in a limited and disguised form by defining association between two parties in detail e.g. trustees, beneficiaries, settlors etc.

If legislated, the proposed rules may be in force from 1 April 2009.

IRD & LAQC AUDITS

In September 2008, the Inland Revenue Department mailed out letters, 45,000 in total, to the directors of every LAQC (Loss Attributing Qualifying Company) that has taxable activity involving residential rentals, as recorded with the IRD.

The objective of this initiative, as we understand it, is to stop situations where a LAQC company owns a domestic residence and lets it back to either the company's shareholders or their family members. Losses arising from such LAQCs are not deductible.

Any disclosures made by the shareholders of these LAQCs as a result of the September mail-out will qualify them for a penalty reduction (of 100%), on the basis that the disclosure is a voluntary pre-audit notification.

Important: This is not advice. Clients should not act solely on the basis of the material contained in the *Client Newsletter*. Items herein are general comments only and do not constitute or convey advice per se. Changes in legislation may occur quickly. We therefore recommend that our formal advice be sought before acting in any of the areas. The *Client Newsletter* is issued as a helpful guide to clients and for their private information. Therefore it should be regarded as confidential and should not be made available to any person without our prior approval. 176/08.