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Property Investors Beware: New Associated Persons Rules

Introduction

With upcoming changes to the associated persons rules, the potential for investment properties to fall into the tax net will skyrocket, and both property developers and investors need to be far more wary when buying property than they were in the past.

The associated persons rules have been a thorn in the side of property investors and developers for many years, and even more so in recent years given the significant value gains in property (at least up until the last 18 months or so) and the resultant focus that the IRD has had on property investors and developers. Whilst these rules have had the potential to catch people out, with a little bit of planning, developers and investors have generally been able to keep gains on investment properties from being taxed. However, with the change in rules there needs to be a change in planning for affected individuals.

Background/Context

In March 2007, the Inland Revenue Department released a discussion paper regarding the associated persons rules under the Income Tax Act. These rules are used throughout the Income Tax Act for a number of purposes. For the purposes of this article, we are just focusing on the associated persons rules relating to land transactions.

The associated persons rules were initially applied to land transactions in 1973 to combat a perception that developers were trying to treat development activities as investment.

The 2007 discussion paper proposed a number of changes both to close perceived loopholes in the "associated persons" definition, which were said to be undermining the integrity of the tax base, and to simplify the legislation, so that there was only one definition for associated persons that applied throughout the legislation (subject to certain exceptions).

Whilst we do not want to comment extensively on the underlying policy for the changes, we note that under the old regime, it was possible for a developer to operate two businesses; a development business, which was taxed, and an investment business which was not. The new rules seem to be an attempt to prevent a developer from having two separate businesses. The government appears to be taking the view that all property held by a developer is held on revenue account (ie. taxable on sale), unless a developer holds investment property for 10 years or more.

Given this change in policy, it is even more important for people involved in property investment and development to be aware of the impacts that the new associated persons rules will have on their businesses.

Please note that these changes apply to builders and land dealers as well. When we refer to developers in this article, you should be aware that the same points apply to builders and land dealers.

The Changes

The effective date for the changes has been deferred a couple of times. The changes are now due to come into force in July or August of this year.

The main changes to the associated person definition:

- widen the kinds of relationships with trusts that can lead to an association;
- provide for rules aggregating interests held in companies, so that two companies become associated if they are owned/

controlled by shareholders with a close relationship; and

- introducing a tri-partite test so that if person A is associated with person B and person B is associated with person C, then person A is associated with person C.

This means (by way of example) that now:

- two trusts with the same settlor will be associated;
- a trust and a person with the power to appoint and remove the trustees of that trust will be associated;
- two companies with more than one shareholder who are associated and between them hold 50% or more of the shares will be associated;
- a trust will be associated with a company where the spouse of one of the beneficiaries of the trust holds 25% of the shares in that company.

There are a number of other situations in which the associated persons definition now applies where it previously wouldn't, particularly given the tri-partite test. We cannot run through these exhaustively here, and have only set out a few examples of the breadth of the new test.

How Does this Affect You?

One thing it is very important to remember is that these changes are not retrospective. This means that any structures you have in place today will still work with respect to any properties which were owned within that structure before the new rules come into force.

Furthermore, if you are a developer, and purchase development properties after the new rules come into force, then again, the new rules will have no impact, as this transaction would be taxable anyway.

The situation that should keep property developers and investors up at night is when they are buying an investment property after the new rules come into force. If you are associated with a developer at the time of purchasing the investment property, then a sale of that property within 10 years of acquisition will be taxable.

Likewise, if you are a developer, and you want to buy property for investment purposes after the new rules come into place, your existing investment structures will very likely no longer be quarantined from your development activities.

What can you do?

If you have a separate development and investment structure, then you should seek advice on how the changes will impact on your businesses. There may be changes that we can make to the structures, so that you can still operate two different businesses and keep them separate for the purposes of the associated persons test.

Otherwise, the main trigger for doing something will be when you are looking to buy an investment property. At that point, (regardless of whether you are a developer or not) you should seek advice on the kinds of structures to use to ensure that the investment property is acquired and remains on capital account.

If you require any advice as to how the new legislation will affect your business, please contact our Property/Tax Team.



If you would like more information, please contact **Matthew Whimp**, Wellington Office, (04) 472-0020.

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